UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES LITIGATION	Civil Action No. H-01-3624 **(Consolidated)**
	CLASS ACTION
This Document Relates To:	
MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, vs. ENRON CORP , et al., Defendants	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, vs. KENNETH L. LAY, et al., Defendants.	

PLAINTIFFS' MEMORANDUM OF LAW IN OPPOSITION TO MOTIONS TO DISMISS FILED BY ROBERT A. BELFER, NORMAN P. BLAKE, JR., RONNIE C. CHAN, JOHN H. DUNCAN, JOE H. FOY, WENDY L. GRAMM, ROBERT JAEDICKE, CHARLES A. LEMAISTRE, JOHN MENDELSOHN, JEROME MEYER, PAULO FERRAZ PEREIRA, FRANK SAVAGE, JOHN WAKEHAM, CHARLS E. WALKER, HERBERT S. WINOKUR AND JOHN A. URQUHART

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I. Introduction

In the wake of the most brazen, massive corporate fraud in history – a fraud that cost thousands of investors their pension plans and hard-earned life savings – this securities class action was brought on behalf of purchasers of Enron's publicly traded equity and debt securities between 10/19/98 and 11/27/01 (the "Class Period"). Defendants are Enron's top executives and directors as well as Enron's auditor and its affiliated entities and partners (collectively, "Andersen"), the law firms of Vinson & Elkins and Kirkland & Ellis, and Enron's banks.

The motions to dismiss filed by the following Enron Defendants are addressed in this memorandum: Belfer, Blake, Chan, Duncan, Foy, Gramm, Jaedicke, LeMaistre, Mendelsohn, Meyer, Pereira, Savage, Urquhart, Wakeham, Walker, Winokur (the "Outside Directors").[1] Defendants Mendelsohn, Meyer, Pereira, Savage, Urquhart, Wakeham, Walker and Winokur are sued only under claims for violations of §§11 and 15 of the Securities Act, for which the Consolidated Complaint ("CC") expressly excluded and disclaimed allegations that could be construed as alleging fraud. ¶1005.[2] Thus, descriptions herein of the Outside Directors' involvement in Enron's scheme to defraud do not apply to Mendelsohn, Meyer, Pereira, Savage, Urquhart, Wakeham, Walker and Winokur.

Despite a detailed and specific CC describing the enormity of the fraud, Enron's outside directors – whose approval of fraudulent transactions, conflicts of interest and deceptive accounting were at the center of the fraud – now move to dismiss the CC. The CC sets out in great particularity the participation of each of the Outside Directors in the Enron scheme. The CC alleges with particularity, the who, what, when, where, and why of each statement, signed by each Outside Director. Further, the CC avers specific facts that describe manipulative and deceptive devices these board members used to defraud Enron's investors, as well as their knowing and reckless participation

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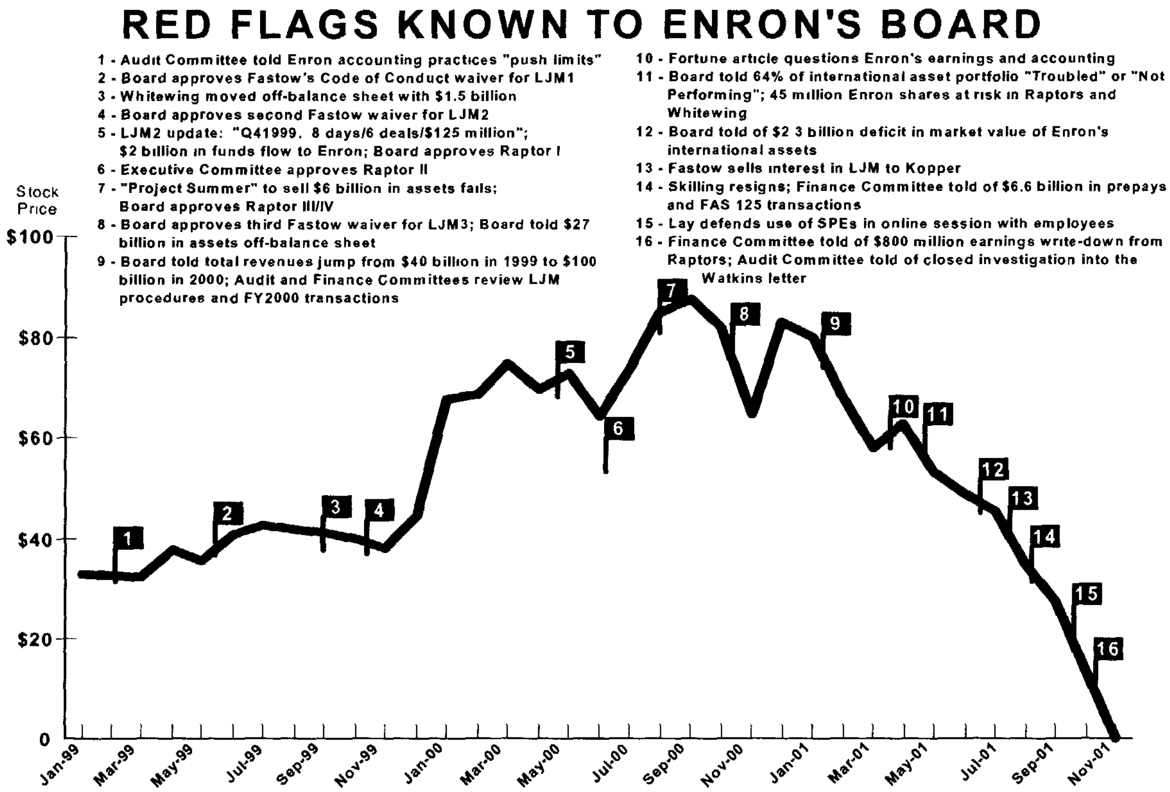
1 This brief responds to the following briefs filed by the Outside Directors: Motion to Dismiss of Defendants Robert A. Belfer, Norman P. Blake, Jr., Ronnie C. Chan, John H. Duncan, Joe H. Foy, Wendy L Gramm, Robert Jaedicke, Charles A LeMaistre, John Mendelsohn, Jerome Meyer, Paulo Ferraz Pereira, Frank Savage, John Wakeham, Charls E. Walker, and Herbert S Winokur ("Outside Dir Br "), filed jointly, and responds as well to the separately filed brief of John A. Urquhart

2 All "¶__" references are to plaintiffs' CC filed 4/8/02.

in various elements of Enron's scheme to defraud. Each of the individual Outside Director defendants served on Enron's board of directors (the "Board") and one or more of the Executive, Finance or Audit Committees. The CC describes specific fraudulent transactions and states that the outside directors, as Board and committee members, knew about them and approved them.

The Outside Director's brief reads as if these directors had nothing to do with Enron, and it was some other group of directors who approved Enron's fraudulent transactions, conflicts of interest, and accounting manipulations The CC contains a barrage of factual allegations that pertain to each Outside Director. The CC goes far beyond alleging what the Outside Directors "must have known." The CC and other materials properly considered in this motion to dismiss describe dozens of fraudulent transactions the details of which were presented to the Board and approved by the Board and its committees.

In fact the Outside Directors were deeply involved in reviewing and approving the very transactions that are central to the CC, and that were key to Enron's financial fraud. These were not insignificant, remote or even isolated, or discreet transactions, but major elements of Enron's business that were accomplished with the full knowledge of their risks and impropriety by the Board This chart, prepared by Congress, vividly shows what the Outside Directors knew and ignored in making their false and misleading statements.



Source U S Senate Permanent Subcommittee on Investigations, May 2002

II. Statement of Facts

The alleged fraudulent scheme and course of business involving Enron finds its origins in mid-97 when Enron suffered huge losses on British natural gas and MTBE transactions which called into question its trading and financial risk management statistics. Analysts downgraded Enron's stock and lowered their forecasts of Enron's future earnings growth. Enron's stock lost one-third of its value and Enron's executives' performance-based bonuses were slashed. Enron was determined to halt its stock's decline and push it back to higher levels. Enron knew this could only be accomplished by reporting stronger-than-expected financial results, thus enabling it to credibly forecast stronger future earnings growth. Unfortunately, Enron's actual business operations were not capable of generating such results. ¶8.

A. Year-End 97 Crisis

To make matters worse, in late 12/97, Enron learned that an entity it had established with an outside investor, Joint Energy Development Incorporated ("JEDI") – and had done transactions with to generate 40% of the profits Enron reported during 97 – had to be restructured, as the outside investor was going to withdraw from JEDI. This created a crisis. Because the outside investor in JEDI had been independent of Enron, JEDI had not been consolidated into Enron's financial statements, *i.e.,* Enron did deals with JEDI as an independent party, recognized profits and did not carry JEDI's debt on its books. Thus, unless JEDI could be quickly restructured with a new, independent investor, Enron would have to wipe out all of the profitable transactions it had done with JEDI in 97, put JEDI's $700 million debt on Enron's balance sheet, and lose the ability to generate profits from similar deals with JEDI's successor going forward. ¶9.

However, Enron could not find a legitimate buyer for the outside investor's interest in JEDI. So Enron quickly formed "Chewco," which Enron controlled, to buy the outside investor's interest in JEDI. Chewco did not have an outside equity investor which was an independent third party. So, Barclays Bank loaned $240 million to Chewco to fund the purchase, requiring a secret guarantee from Enron. Barclays also loaned the money to two straw parties (Little River and Big River) to provide for their purported "equity" investment in Chewco. Because Barclays knew that the purported equity investors in Chewco were, in fact, Enron "strawmen," Barclays required Chewco to support the purported "equity loans" Barclays made to the two "strawmen" via a $6.6 million reserve paid to Barclays! Because there was no independent outside investor in Chewco, Chewco was required to have been consolidated with Enron and all of Enron's 97 profits from transactions with JEDI should have been eliminated! ¶10. The Board members knew of the details of this transaction and, most importantly, voted to waive Enron's Business Conduct Policy to allow CFO Andrew Fastow to operate LJM2 under a conflict of interest. The transaction was in fact presented in detail and approved at a 11/5/97 meeting of the Executive Committee of Enron's Board.[3]

By the year-end 97 non-arm's-length Chewco transaction, Enron avoided a disaster by keeping the previously recorded JEDI profits in place, inflating Enron's 97 reported profits, and keeping millions of dollars of debt off its books. Chewco was now also positioned to serve as a controlled entity with which Enron could do non-arm's-length transactions, creating at least $350

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[3] Ex. 21. Unless otherwise noted, all exhibits are attached to plaintiffs' Appendix.

million in phony profits for Enron and allowing Enron to conceal millions of dollars of debt. Between 98 and 01, Enron, and other of its bankers, would create other controlled partnerships and entities and use them to generate hundreds of millions of dollars of phony profits while concealing billions of dollars of Enron debt. ¶11.

B. The 97-00 Successes – Enron's Stock Soars

As Enron reported better-than-expected year-end 97 financial results, its stock moved higher. During 98 through mid-01, Enron appeared to evolve into an enormously profitable high-growth enterprise, reaching annual revenues of $100 billion by 00, with annual profits of $1.2 billion, presenting a very strong balance sheet that entitled it to an investment grade credit rating. By 01, Enron had become the 7th largest U.S. corporation, was consistently reporting higher-than-forecasted earnings each quarter, and forecasting continued strong growth. ¶¶12-13.

Enron extolled the success and earning power of its Wholesale Energy trading business ("WEOS"), its retail Energy Services business ("EES"), and its Broadband Content Delivery and Access Trading, *i.e.,* intermediation, business ("EBS"). ¶2. Throughout 98 and 99, as Enron reported record profits and a strong financial position, Enron, in releases, reports and conversations with investors and analysts and Enron's banks, in analyst reports, stated (¶14(a)):

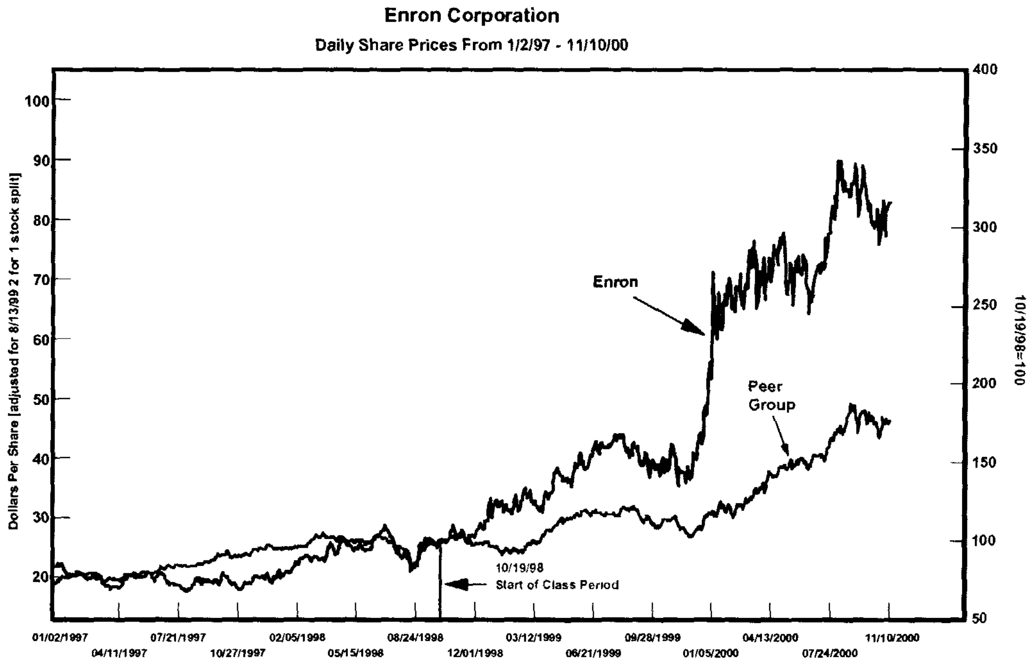
- Enron's strong results were due to the success of all of its business lines.
- Enron had a leading position in each of its businesses. Enron had an extremely strong franchise position.
- Wessex Water would be accretive to Enron's business now and a $20 billion business in five years. Azurix Corp. was becoming a major global water company.
- International projects would drive major earnings growth for Enron. The Dabhol, India power project would contribute to earnings in 99 and beyond.
- WEOS's business remained strong.
- EES was exceeding expectations for contracts and profitability. EES was adding billions in new contracts and would be profitable by 4thQ 00.
- Enron was optimistic about its broadband business. EBS was firing on track.
- Enron's tremendous competitive advantages enabled it to achieve strong EPS growth.
- Enron was very well managed and knew how to manage and mitigate risk. Enron had effectively used off-balance sheet non-recourse financing. Enron had a strong balance sheet. Enron was a master of risk management.

- No other company offered such impressive sustainable growth.
- Enron was hitting on all eight cylinders. Enron's outlook was excellent. Enron was very optimistic.
- Enron was a global powerhouse, with EPS growth to exceed 17%. Enron would maintain strong earnings growth for years.

During 00, as Enron reported record annual profits and a very strong financial position, Enron and its banks stated (¶14(b)):

- Enron's strong financial results were due to strong results in all operations.
- Enron had very strong momentum. Its new trends were sustainable and would accelerate.
- Enron's business was booming. All its operations were gaining momentum.
- Investors were about to see breakout performance of EES and rapid growth and development of EBS.
- EES's new contracts and profitability were accelerating. EES had the potential to double Enron's size in a few years.
- EBS broadband trading was accelerating. The market was larger than expected, and would reach $100 billion in a few years with 3%-4% margins.
- Enron/Blockbuster video-on-demand ("VOD") deal a "killer app." Unparalleled quality of service. Contract worth over $1 billion. VOD to rollout nationally in 01. All components in place. VOD had solid technology and platform.
- Enron's WEOS merchant investments were protected through hedging.
- Enron had monumental earnings potential over the next five years. Enron was well managed and a pioneer in global energy Enron was never in better shape. Enron was very optimistic about the continued strong outlook for the Company.
- Growth and strong earnings were why investors should buy Enron stock.

As a result of Enron's strong earnings, the positive statements about its business and the forecasts of continuing strong earnings growth, Enron's stock was a very strong performer. Enron's apparent success and forecasts of strong profit growth gave Enron ready access to the capital markets by which it raised billions of dollars by selling newly issued Enron securities to public investors, using the proceeds to repay Enron's bank debt. ¶16. Enron's stock soared to its all-time high of $90-3/4 in 8/00 and then continued to trade at or near this level for months, as shown below (¶15):



But the apparent success of Enron was an illusion – a false picture created by manipulative and deceptive devices and contrivances – a fraudulent scheme and course of business by defendants that operated as a fraud and deceit on the purchasers of Enron's publicly traded securities. ¶17. The fraudulent scheme was accomplished with the full knowledge of the Board on which the Outside Directors sat. The Board members, especially Belfer, Blake, Chan, Duncan, Foy, Gramm, Jaedicke, LeMaistre and Mendelsohn, who were on one or more of the Executive, Finance, and Audit Committees knew of and approved every large transaction by which Enron hid debt and falsified profits. ¶395.[4]

Enron's investment grade credit rating was indispensable to enabling it to get counterparties to do huge trading transactions with it – transactions others would not do unless assured of Enron's creditworthiness. Since Enron's trading of energy resources was the core of its WEOS business, any downgrade of its credit rating would have disastrous consequences for its core business operation. This investment grade credit rating gave Enron access to the commercial paper market – a market reserved for America's largest and most creditworthy corporations – so that it could borrow billions

4 *See, e.g.*, Exs. 21, 24 and 26.

of dollars to maintain its liquidity and finance its capital-intensive business. Enron's access to the commercial paper market also meant that Enron's $3 billion commercial paper back-up credit line, arranged by the lead banks (J.P. Morgan and CitiGroup) with participating banks, would not be drawn down upon, thus limiting those banks' financial exposure to Enron. It also meant that Enron and its banks could easily sell debt securities to public investors to raise long-term capital, using the proceeds to reduce its short-term commercial paper and other bank debt. Finally, Enron's investment grade credit rating was critical to the scheme, as only Enron's insiders and its banks knew, because under the terms of the partnerships/SPE deals, if Enron's debt was downgraded to below investment grade, the debt of those entities that they had told the securities markets was non-recourse as to Enron would become recourse to Enron, which could cause the house of cards to topple. As Enron's CFO stated in a 10/01 conference call: "***We understand that our credit rating is critical to both the capital markets as well as our counterparties***." Earlier, Fastow stated to *CFO Magazine*: "***My credit rating is strategically critical***." ***In 10/99, Skilling said, "Retaining a high investment-grade rating is critical to the success of our energy franchises .... If we were downgraded, we could lose critical market share in North America***." ¶19.

Inside Enron there was a fixation on Enron's stock and doing whatever was necessary to generate the financial results necessary to push the stock ever higher. Throughout Enron's corporate headquarters in Houston were TV monitors that constantly displayed the price of Enron stock. Inside there was a saying that managers were to always be "ABCing," meaning to "always be closing" deals to generate revenues and profits, even if the economics of the deal were suspect – a practice facilitated by a compensation system inside Enron for corporate managers and executives that directly rewarded them financially for closing transactions and placing a high (*i.e.,* inflated) value on them, regardless of the true economic substance of the deal, so long as the deal generated an apparent profit when "marked to market." ¶50. It was Enron's Board that knew of and approved this executive compensation structure, as evidenced by its creation of a Compensation and Management Development Committee.

Inside Enron, the pressures applied to corporate managers by the top executives to do anything necessary to enable Enron to make its numbers was widespread, as was the knowledge that

Enron's revenues and earnings were being falsified at the direction of top executives who rewarded the lower level managers who engaged in such conduct with bonuses in larger amounts to those who were willing to facilitate what had become a Company-wide fraudulent pattern of behavior. ¶51.

Former insiders have been quoted as saying "[y]ou don't object to anything" and "[t]he whole culture at the vice-president level and above just became a yes-man culture." ¶51. Yet Enron's directors routinely approved the fraudulent and highly suspect transactions that management proposed. *See* Exs. 21, 24. But that culture had a negative side beyond the inbred arrogance. Greed was evident, even in the early days. "More than anywhere else, they talked about how much money we would make," says someone who worked for Skilling. Board-approved compensation plans often seemed oriented toward enriching executives rather than generating profits for shareholders. For instance, in Enron's energy services division, which managed the energy needs of large companies like Eli Lilly, executives were compensated based on a market valuation formula that relied on internal estimates. ¶51. At an October 11 and 12, 1999 meeting, Enron's full Board received a detailed presentation by Skilling about EES and its operational and financial aspects. Ex. 24. As a result, says one former executive, there was pressure to, in effect, inflate the value of the contracts – even though it had no impact on the actual cash that was generated.

> ***"If your boss was [fudging], and you have never worked anywhere else, you just assume that everybody fudges earnings," says one young Enron control person. "Once you get there and you realized how it was, do you stand up and lose your job? It was scary. It was easy to get into 'Well, everybody else is doing it, so maybe it isn't so bad.'"***
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> The flaw only grew more pronounced as Enron struggled to meet the wildly optimistic expectations for growth it had set for itself. "You've got someone at the top saying the stock price is the most important thing, which is driven by earnings," says one insider. "Whoever could provide earnings quickly would be promoted."
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> The employee adds that anyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants. She says there was little scrutiny of whether the earnings were real or how they were booked. The more people pushed the envelope with aggressive accounting, she says, the harder they would have to push the next year. ***"It's like being a heroin junkie," she said. "How do you go cold turkey?"***

Business Week, 2/25/02 (¶51).

In fact, in mid-8/01, an Enron executive (who was a former Andersen accountant) wrote Lay, telling him the Company was "nothing but an elaborate accounting hoax," and, in referring to the SPE transactions, that nothing "will protect Enron if these transactions are ever disclosed in the bright light of day" – warning that many employees believed "[W]e're such a crooked company." ¶51.

By 97-98, Enron was a hall of mirrors inside a house of cards – reporting hundreds of millions of dollars of phony profits while concealing billions of dollars of debt that should have been on its balance sheet, inflating its shareholder equity by billions of dollars. Enron had turned into the largest Ponzi scheme in history – constantly raising fresh money by selling its securities or those of related entities, while appearing to achieve successful growth and profits. Enron's Board, including the Outside Directors, approved financing after financing. The Board was fully informed of the need for, and approved numerous large securities offerings and very large loans. ¶18. *See, e.g.*, Ex. 26. But because Enron's reported profits were being generated by phony, non-arm's-length transactions and improper accounting tricks – including the abuse of "mark-to-market" accounting to accelerate the recognition of hundreds of millions of dollars of profits to current periods from transactions in which Enron was only entitled to receive cash over many future years – Enron was cash starved. ¶18.

Enron engaged in several accounting tricks and manipulations to falsify its financial results during the Class Period. Chief among these was the abuse of "mark-to-market accounting" whereby Enron computed the purported profit it would ultimately obtain on a multi-year contract, discounted that to present value, and recognized the entire "mark-to-market" profit in the current period. Unless Enron's expected profit on the transaction was truly hedged, Enron was required in each following quarter to recompute or readjust the profit computation to adjust for changing economic values. "Mark-to-market" accounting was appropriate ***only*** where Enron had a long-term track record, which gave it the ability to accurately estimate and forecast future values (as was true with certain aspects of Enron's wholesale energy business) However, Enron misused and abused mark-to-market accounting throughout its entire business to grossly inflate its reported revenues and profits. In

Enron's business this was done by assigning unrealistic values to wholesale energy transactions, which inflated current-period income. ¶36.

In its EES business, where Enron had no long-term track record to justify the use of mark-to-market accounting, Enron nevertheless consistently utilized mark-to-market accounting to record huge current period profits on long-term, highly speculative retail energy risk-management contracts which, in fact, Enron had no basis to project a profit on and, in fact, knew would likely result in losses. Finally, in Enron's EBS business – also a new business where Enron had absolutely no track record which would justify the use of mark-to-market accounting – Enron abused mark-to-market accounting to generate hundreds of millions of dollars of phony current period profits in several transactions. Enron not only abused mark-to-market accounting to initially value multi-year transactions to generate inflated current period profits, it also, when reviewing those computations on a quarterly basis as it was required to do, consistently ***increased*** the estimated value of the transaction even though subsequent data revealed a reduction of the estimated value of the transaction was appropriate, a practice known within Enron as "moving the curve." ¶36.

In at least two meetings of the Audit Committee in 2/99 and 5/00, the Board received actual notice of the high-risk nature of such practices, their highly judgmental and subjective nature, and their enormous consequences on Enron's reported earnings. Ex. 16.

Yet to continue to report growing profits, Enron was forced not only to continue to engage in such transactions and accounting abuses, but to accelerate the number and size of such transactions it engaged in. These reckless transactions and practices were routinely presented and repeatedly approved by the Board without further inquiry, or putting in place controls. ¶18. *See, e.g.*, Ex. 24.

To make matters worse, Enron had capitalized certain controlled entities it was doing phony deals with using shares of Enron stock and had agreed to issue millions of additional shares to these entities if Enron's stock price declined below certain "trigger prices," *i.e.*, \$83, \$81, \$79, \$68, \$60, \$57, \$52, \$48, \$34 and \$19 per share, and to become liable for the debt of those entities if Enron lost its investment grade credit rating. Because of the stock-price triggers and the way Enron capitalized these entities, it was absolutely vital to Enron, and the other participants in the fraudulent scheme and course of business, that Enron's stock continue to trade at high levels and that Enron maintain its investment grade credit rating, otherwise the scheme would unravel. ¶20.

The CC alleges that the Outside Directors knew about and approved of these deal structures. ¶¶395, 398. In 5/01, the Board received a full presentation about the Raptor entities and had before it the information to understand that these entities were ***not*** creditworthy counterparties and that any hedges they sold Enron were shams. Ex. 26. Also at an 10/6/00 Finance Committee meeting, Enron Treasurer Ben Glisan told the Board of a "significant increase" in the Company's guarantee portfolio. Ex. 27.

Enron became completely dependent on maintaining its investment grade credit rating and a high stock price so that Enron could continue to have access to the capital markets to borrow billions in commercial paper and to enable it to periodically raise hundreds of millions of dollars of new longer term capital it needed to repay its commercial paper debt and the short-term loans it was receiving from its banks to sustain its business operations and so the stock-issuance price triggers would not be hit, which would force Enron into a death spiral. ¶20.

The director defendants knew the significance of Enron's investment grade credit rating to its economic survival. As Enron's CFO Fastow stated in a 10/01 conference call: "We understand that our credit rating is critical to both the capital markets as well as our counterparties." Earlier, he had stated to *CFO Magazine*: "My credit rating is strategically critical." This investment grade credit rating gave Enron access to the commercial paper market – a market reserved for America's largest and most creditworthy corporations – so that it could borrow billions of dollars to maintain its liquidity and finance its capital-intensive business. Enron's investment grade credit rating was critical to the scheme, as Enron's insiders and its banks knew, because under the terms of the partnership/SPE deals, if Enron's debt was downgraded to below investment grade, the debt of those entities would become recourse to Enron, which could cause the house of cards to topple. ¶19

C. The Partnerships and SPEs

To falsify its reported financial condition and results, Enron engaged in a series of purported partnership and related-party transactions with special-purpose entities known as SPEs. A public company that conducts business with an SPE may treat that SPE as if it were an independent entity

only if it does ***not control*** the SPE. And, at a bare minimum, two other conditions must be met: (i) an independent party must make an equity investment of at least 3% of the SPE's assets, which must remain at risk throughout the transaction; and (ii) the independent party must exercise control of the SPE. ¶21. Because of the material size of these structured transactions and their vital importance to Enron's earnings and entire financial structure, the Board had full knowledge of and approved these transactions. ¶¶395, 398. Moreover, it was apparent and obvious that Enron, in fact, exercised real control over these SPEs, at the very least because CFO Fastow was their general partner. *See, e.g.,* Exs. 21, 24.

In 99, Enron created two LJM partnerships (LJM and LJM2), which Enron secretly controlled. Enron then engaged in numerous transactions – in fact, manipulative and deceptive contrivances – with LJM2 and associated SPEs, which inflated Enron's reported profits by more than a billion dollars, at the same time enriching Fastow and his friends and all of Enron's banks. The reason for establishing LJM2 was that it would permit Enron to accomplish transactions it could not otherwise accomplish with an independent entity, by providing Enron with a buyer of assets that Enron wanted to sell. ¶23. This was explicitly stated to the Board and was, in fact, the supposed justification given to the Board for why it should waive Fastow's duty of undivided loyalty to Enron's shareholders in order to allow his participation in the SPEs. Ex. 24. To do so the Board waived Enron's Business Conduct Policy, but it could not waive the obvious fact that real financial control of LJM2 rested with Fastow and thus with Enron. Indeed, LJM2 was one of the primary vehicles used to falsify Enron's financial results during 99-01. LJM2 was secretly controlled by Enron and used to create numerous SPEs, including the infamous Raptor vehicles, which engaged in numerous non-arm's-length fraudulent transactions with Enron, to artificially inflate Enron's profits while concealing billions of dollars of its debt on terms so unfair to Enron that the deals would provide huge returns to the LJM2 investors. Simply stated, the Board approved the establishment of LJM2 and its structure, including waiving CFO Fastow's conflict-of-interest participation. Moreover, the fiction of outside control of LJM and LJM2 is clearly belied in board and committee minutes. CFO Fastow would update Enron's Board on the benefits and transactions of the LJM entities, making it clear that their financial control was with Enron. *See, e.g.,* Exs. 23, 24; Hearing of the Oversight and

Investigations Subcommittee of the House Energy & Commerce Committee, 2/7/02 ("2/7/02 Committee Hearing").

Because the LJM2 partnership was going to be so lucrative to investors in that entity, and provide exceptional returns as the Enron Ponzi scheme continued, the Board was informed that in funding LJM2 Enron would allow certain high-level officers of Enron's investment banks to invest in LJM2. ¶25. *See* 10/11/99 Finance Committee meeting (Ex. 23), in which "Causey, Fastow, and Skilling answered questions from the Committee concerning the role of other [LJM2] partners." The LJM2 partnership offering memorandum, by which Enron and Merrill Lynch brought investors into the partnership – which was not a public document – contained an invitation to benefit from the self-dealing transactions that LJM2 would engage in. It emphasized Fastow's position as Enron's CFO, and that LJM2's day-to-day activities would be managed by Fastow and other Enron insiders. It explained that "[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities" and that it "expects to benefit from having the opportunity to invest [some $150 million] in Enron-generated investment opportunities that would not be available otherwise to outside investors." It specifically noted that Fastow's "access to Enron's information pertaining to potential investments will contribute to superior returns." In addition, investors were told that investors in a similar Fastow controlled partnership – JEDI – that had done deals with Enron like the ones LJM2 would do had tripled their investment in just two years, and that overall returns of 2,500% to LJM2 investors were actually anticipated. Enron and its Board knew that because LJM2 was going to engage in transactions with Enron where insiders would be on both sides of the transactions, the LJM2 partnership would be extremely lucrative – a deal that was virtually guaranteed to provide huge returns to LJM2's investors as the Enron Ponzi scheme went forward. ¶25.

In short, the non-public LJM2 offering memorandum was an invitation to join in the benefits of non-arm's-length self-dealing transactions with Enron – an opportunity and invitation to loot it. Enron's bankers and the top executives of those banks were permitted to invest in LJM2 as a reward for their ongoing participation in the scheme – a sure thing for them. Thus, the director defendants, having blessed Fastow to act outside the boundaries of Enron's Business Conduct Policy – indeed outside the boundaries of generally accepted business ethics – were active and knowing participants in the scheme to transfer wealth to bankers and insiders to the detriment of the shareholders of Enron. ¶646.

It was indispensable to the scheme that LJM2 be funded by year-end 99 to serve as a vehicle to consummate several transactions with Enron before year-end 99 to create huge profits for Enron in the 4thQ 99 so that Enron could meet and exceed its forecasted 99 earnings. ¶26. However, as had been the case with Chewco at year-end 97, there was tremendous time pressure and Enron could not complete the formation of LJM2 and raise money from the equity investors in LJM2 in time to actually form or fully fund LJM2 by year-end 99 with sufficient capital to enable it to do the desperately needed transactions with Enron. So, in an extraordinary step, on 12/22/99, the Board was aware that Enron's bankers put up money to pre-fund LJM2 in 12/99, enabling Enron to do the 99 year-end deals with LJM2 and its SPEs that were indispensable to Enron avoiding reporting a very bad 4thQ 99, which would have caused its stock to plunge. These deals included collateralized loan obligations, Nowa Sarzyna (the Poland Power Plant), MEGS (a natural gas system in the Gulf of Mexico), and Yosemite, all described in detail in the CC. ¶28.

From 6/99 through 6/01, the Board had actual knowledge that Enron entered into numerous non-arm's-length transactions with the LJM partnerships. Enron sold assets to LJM that it wanted to get off its books on terms that no independent third party would ever have agreed to. The transactions between the LJM partnerships and Enron or its affiliates occurred close to the end of financial-reporting periods to artificially boost reported results to meet forecasts Enron and other participants in the scheme had been making. For instance, near the end of the 3rdQ and 4thQ 99, Enron sold interests in seven assets to LJM and LJM2, which permitted Enron to conceal its true debt levels by removing the assets from its balance sheet and, at the same time, record large gains. As it had agreed to do in advance, Enron bought back five of the seven assets after the close of the financial reporting period, and the LJM partnerships made large profits on every transaction, even when the asset they had purchased actually declined in market value, and those transactions generated purported earnings for Enron of $229 million in the second half of 99 out of total earnings for that period of $549 million. In three of these transactions where Enron ultimately bought back

LJM's interest, Enron had agreed in advance to protect the LJM partnerships against any loss. ***In sum***, the LJM partnerships functioned only as vehicles to accommodate defendants in the manipulation, falsification and artificial inflation of Enron's reported financial results, while enriching the LJM investors to the detriment of Enron's shareholders. ¶32.

These favored investors in LJM2, in particular many of Enron's bankers, actually witnessed a series of extraordinary pay outs from the Raptor SPEs, which LJM2 controlled, over the next two years, securing hundreds of millions of dollars in distributions from the Raptors to LJM2 and then to themselves – cash generated by the illicit and improper transactions Enron was engaging in, *e.g.*, the manipulative and deceptive devices, with the Raptors to falsify Enron's financial results ¶646.

One "hedging" transaction with LJM in 6/99 involved Rhythms NetConnections ("Rhythms") stock owned by Enron. To "hedge" Enron's huge gains in Rhythms stock and enable Enron to create a huge profit, Enron transferred its own stock to the SPE in exchange for a note. But if the SPE were required to pay Enron on the "hedge," the Enron stock would be the source of payment. Other false hedging transactions occurred in 00 and 01 and involved SPEs known as the "Raptor" vehicles. These were also structures, funded principally with Enron's own stock, that were intended to hedge against declines in the value of certain of Enron's merchant investments. ¶33. The Outside Directors received reports on the structuring and economics of these transactions from Enron's financial officers. *See* Ex. 26.

But these transactions were ***not*** economic hedges. They were manipulative and deceptive devices devised to circumvent accounting rules. And the details of these transactions – every fact needed to understand the underlying financial reality of the transactions and the illusory nature of the hedge, and the affect on Enron's reported profits – were known to the Outside Directors because of the regular reports they received. The economic reality was that Enron ***never*** escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron ¶33 Enron and Enron's banks used these contrivances and manipulative and deceptive devices to inflate Enron's reported financial results. In 99, Enron recognized income of over $100 million from the Rhythms' "hedging" transaction (¶33), which was completely obvious from the information presented to the Board by Treasurer Ben Glisan about the Raptors. The Board had actual knowledge that the

Raptors were capitalized with Enron stock, and actual knowledge that, by recognizing revenue from hedges with a counterparty capitalized with Enron stock, ***Enron would be in reality recognizing revenue based on the appreciation of its own stock, in violation of GAAP***. Ex. 26. In the last two quarters of 00, Enron recognized pre-tax earnings of $530 million on several transactions with the Raptor entities out of reported pre-tax earnings of $650 million. These false earnings from the Raptors' manipulative and deceptive contrivances accounted for more than 80% of the total! ¶33.

Hedging Enron's investments with the value of Enron's stock created an enormous and unusual motive for the participants in the scheme to keep Enron stock trading at inflated price levels. This was because if the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This happened in late 00 and early 01. In 12/00, Enron's gain on these transactions was over $500 million. Enron could recognize these gains – offsetting corresponding losses on the investments in its merchant portfolio – only if the Raptors had the capacity to make good on their debt to Enron. If they did not, Enron would be required to record a "credit reserve," a loss that would defeat the very purpose of the Raptors, which was to shield Enron from reflecting the decline in value of its merchant investments. ¶34.

As year-end 00 approached, two of Enron's LJM2-financed Raptor SPEs were in danger of coming unwound as they lacked sufficient credit capacity to support their obligations. If something were not done to prevent the unwinding of these SPEs, Enron would have to take a multi-million-dollar charge against earnings, which would expose the prior falsification of Enron's financial results and result in Enron's stock price plunging, more and more of the stock-issuance price "triggers" would be hit, and a vicious death-spiral would kick in. ¶35. The Board had notice of this potential crisis: Treasurer Ben Glisan informed the Finance Committee of the "significant increase in the Company's guarantee portfolio." Ex. 27; 2/7/02 Committee Hearing. Consequently, Enron restructured and capitalized the LJM2-financed Raptor SPEs at year-end 00 by transferring to them rights to receive even more shares of Enron stock, creating ever-increasing pressure on Enron and the other participants in the scheme to support Enron's stock price. This artifice enabled Enron to avoid recording a huge credit reserve for the year ended 12/31/00. ¶35. Again, each of Enron's Outside Directors knew about or had access to full information and was complicit in the scheme and fraudulent course of business by approving and implementing these manipulative and deceptive structures.

D. Enron Energy Services ("EES")

The falsification of Enron's financial results was not limited to non-arm's-length fraudulent partnership and SPE transactions. While Enron's wholesale energy business was the largest single contributor to its profits, Enron was also telling investors that an area of tremendous growth for Enron was its retail energy services business – EES – whereby Enron purportedly undertook to manage the energy needs of corporate consumers for multi-year periods in return for fees to be paid over a number of years. Enron and its banks presented this business as achieving tremendous success by constantly signing new multi-million or even billion dollar contracts, which allowed EES to exceed internal forecasts, and that this division had turned profitable in the 4thQ 99 and was achieving substantial gains in its profitability. ¶37. The CC alleges that the Board had knowledge of the EES operations because of its enormous impact on Enron's revenues. ¶¶395, 398. In fact, at an October 6, 2000 board meeting, Skilling informed the Finance Committee that EES's project implementation was lagging behind original projections, that EES had substantial capital expenditures, and that the slow down in project implementation would have a negative effect on earnings. Ex. 27.

In fact, EES was losing hundreds of millions of dollars. To induce large enterprises to sign long-term energy management contracts and jumpstart this business, so it could appear to obtain huge contract volumes, Enron entered into EES management contracts that it knew would likely result in huge losses. By abusing mark-to-market accounting, Enron grossly overvalued the ultimate value of these contracts and created greatly inflated current-period profits from transactions that generated little, if any, current-period cash, and which would likely actually result in long-term cash-out plans and losses. ¶38.

E. More Explicit Actual Notice of Wrongdoing

A letter written in 8/01 to Enron's Board, just after Skilling "resigned," by an EES manager stated (¶38).

((

> ***One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrongdoings of the various management teams at Enron ... (i.e., EES's management's ... hiding losses/SEC violations).***
>
> * * *
>
> ***... [I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked.***
>
> ***... [I]t will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion.... [T]hey decided ... to hide the $500MM in losses that EES was experiencing.... EES has knowingly misrepresented EES['s] earnings. This is common knowledge among all the EES employees, and is actually joked about. But it should be taken seriously.***

F. Enron Broadband ("EBS")

Another purported growth area of Enron's business was its broadband services business – EBS – which consisted of constructing an 18,000-mile fiber optic network which Enron was supposedly successfully building out and engaging in trading access to Enron's and others' fiber optic cable capability, *i.e.*, "Broadband Intermediation." Enron and its banks presented both parts of Enron's broadband business as poised to achieve and later as actually achieving huge success, reporting that its fiber optic network was being or had been successfully constructed, was state of the art and provided unparalleled quality of service, and that its broadband trading business was succeeding and achieving much higher trading volume and revenues than expected, *i.e.*, "exponential growth." ¶39.

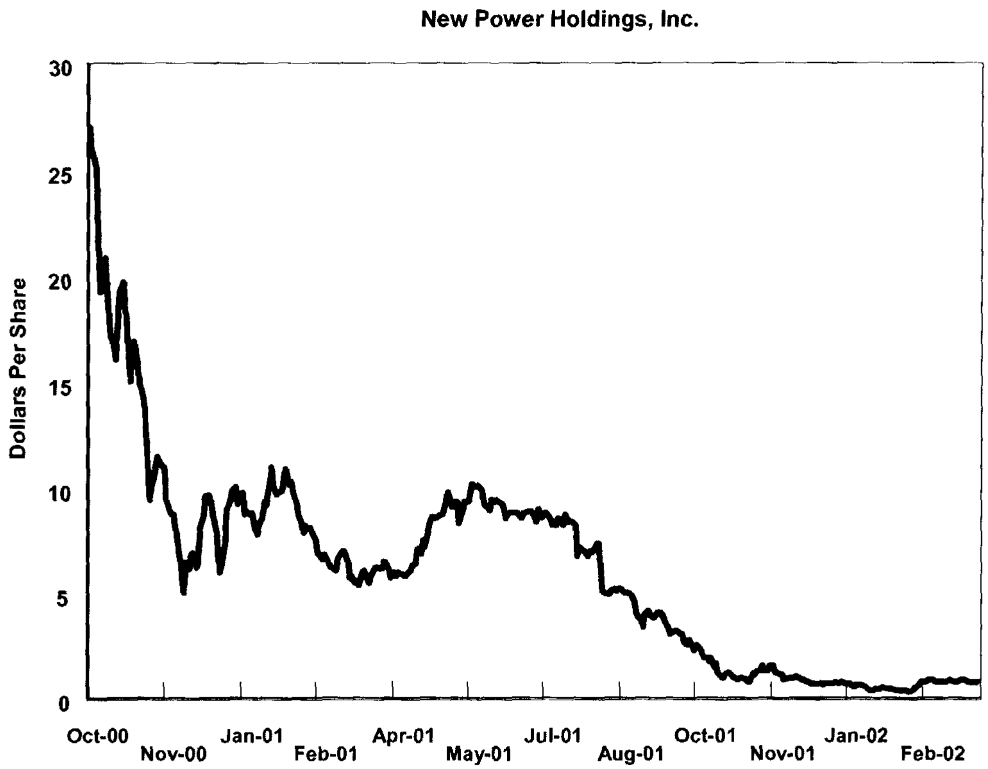
A prime example of the purported success of Enron's broadband content business was its VOD joint venture with Blockbuster, announced in 7/00. Enron presented this 20-year agreement as having a billion dollar value, that it was a first-of-its-kind product whereby consumers would obtain VOD content from Blockbuster in their home as if they were watching the movie on their own VCR (start, stop, rewind) and that this incredible advance in technology was made possible due to the high quality of Enron's fiber optic network. Abusing mark-to-market accounting, Enron recognized an astonishing $110+ million profit on this deal in the 4thQ 99 and 1stQ 00, even though the project failed in its test markets because Enron did not have the technology to deliver the product as represented – and which could never have gone forward because Blockbuster did not have the legal right to deliver movies in digital format, the only format which could be utilized for VOD. ¶40.

As stated above, the Board received an explicit warning from Andersen that there was high accounting risk and "challenges" in applying mark-to-market accounting to transactions in new markets for which there was no historical record on which to base assumptions. Exs. 16, 27.

G. New Power

Another example of how Enron falsified its reported results is the New Power IPO in 10/00, by which Enron improperly created a $370 million profit in the 4thQ 00. Enron controlled New Power and owned millions of shares of New Power stock, thus, if Enron and its banks could take New Power public and create a trading market in its stock, then Enron could recognize a profit on the gain in value on its shares by "hedging" that gain through yet another non-arm's-length transaction via LJM2. In the 4thQ 00, Enron desperately needed to create profits to perpetuate the Ponzi scheme. Enron did the New Power IPO of 27.6 million shares at $21 per share in 10/00. Then, in a deal secretly structured before the IPO, Enron created a phony profit using an LJM2 SPE called Hawaii 125-0. Enron's banks made a "loan" of $125 million to Hawaii 125-0, but secretly received a "total return swap" guarantee to protect them against any loss from Enron. Enron transferred millions of New Power warrants to Hawaii 125-0 to "secure" the banks' loan and thus created a huge $370 million "profit" on the purported gain on the New Power warrants. ¶42.

Hawaii 125-0 simultaneously supposedly "hedged" the warrants with another entity created and controlled by Enron called "Porcupine." To supposedly capitalize Porcupine, LJM2 put $30 million into Porcupine to facilitate the so-called hedge of the New Power warrants, but, one week later, Porcupine paid the $30 million back to LJM2 plus a $9.5 million profit – leaving Porcupine with no assets. New Power stock immediately fell sharply, as the chart below shows:



This collapse converted Enron's huge gain on its New Power equity holdings into a huge loss early in 01 – a loss of about $250 million – which was concealed. ¶42.

H. Hidden/Disguised Loans

Another tactic utilized by Enron and its banks to falsify Enron's financial condition and hide debt involved manipulative or deceptive transactions with J.P. Morgan, CitiGroup and CS First Boston. J.P. Morgan used an entity it controlled known as "Mahonia," located in the Channel Islands off England. J.P. Morgan and Enron utilized a scheme which J.P. Morgan had utilized before with a commodities trader from Sumitomo, by which large bank loans were disguised as commodity trades. In fact, offsetting trades were arranged with the ultimate cost differential being in favor of the bank, representing the interest rate on the disguised loan. By utilizing this manipulative or deceptive device, J.P. Morgan and Enron falsified Enron's financial condition, concealing some $4 billion in debt ¶44.[5]

CitiGroup and CS First Boston engaged in similar subterfuges to disguise large loans to Enron. CitiGroup lent Enron $2.4 billion via "pre-paid" swaps – the so-called "Delta" transactions – conducted through CitiGroup's Cayman Islands subsidiary. These swap transactions perfectly replicated loans and were, in fact, loans – but Enron never reported them as such on its balance sheet. CS First Boston also engaged in making disguised loans to Enron. CS First Boston gave Enron $150 million to be repaid over two years, with Enron's payments to vary with the price of oil. The transaction was made to appear to be a "swap," but was, in fact, a loan – a reality admitted by the bank: "***It was like a floating-rate loan***," said Pen Pendleton, a CS First Boston spokesman. "***We booked the transaction as a loan***." However, Enron did not show the loans on its balance sheet. ¶45.

By so doing, J.P. Morgan, CitiGroup and CS First Boston were able to ***secretly*** prop up Enron's deteriorating finances without disclosing that in fact Enron ***had borrowed between $4-$6 billion from those banks***. Also astonishing about the Mahonia and Delta transactions is the way J.P. Morgan and CitiGroup were "***paid off***" to engage in this subterfuge. Based on Enron's purported investment grade credit rating, Enron could have borrowed money from banks at 3.75%-4.25%. However, in the phony Mahonia and Delta transactions, ***Enron paid J.P. Morgan and CitiGroup between 6.5%-7.0% for the disguised loans – a huge difference from the cost of a legitimate bank loan – which made these disguised loans hugely profitable for J.P. Morgan and CitiGroup*** – in effect paying them off for participating in these bogus transactions. ¶46.

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[5] Knowing Enron's true financial condition was precarious, J.P. Morgan attempted to insure against default on those disguised loans by buying performance bonds from several insurance companies. However, the insurers have refused to pay, alleging that in fact the commodity trades were fraudulent and a subterfuge to conceal the real nature of the transactions, *i.e.*, done for the purpose of disguising loans. ***A federal district court judge has ruled that there is significant evidence to support the insurers' claims of fraud and deception and that these transactions were, in fact, disguised loans***. ¶44.

I. Enron's Access to the Capital Markets

Enron required constant access to huge amounts of capital. For Enron to continue to appear to succeed it had to keep its investment grade credit rating and keep its stock price high. Enron's investment grade credit rating and high stock price could only be maintained by (i) limiting the amount of debt shown on Enron's balance sheet; (ii) reporting strong current period earnings; and (iii) forecasting strong future revenue and earnings growth. Yet Enron was able to achieve these ends only by pursuing an increasing number of phony transactions, many of which were accomplished by increasing the number and size of transaction entities which were supposedly independent of Enron but which, in fact, Enron controlled through a series of secret understandings and illicit financing arrangements, including the Chewco, LJM and LJM2 partnerships, all presented to the Outside Directors at various meetings, either of the complete Board or of its Finance, Audit or Executive Committees. As a result of reporting strong earnings, the apparent success of its business and its future earnings growth forecasts, Enron had unlimited access to the capital markets, borrowing billions of dollars in the commercial paper markets and selling billions of dollars of Enron securities to the public. Enron and its bankers, with the approval of the Outside Directors, raised billions in new debt and equity capital from public investors for Enron or associated entities through numerous securities offerings, thus raising the capital necessary to allow Enron to repay or pay down its short-term debt and continue to operate. ¶48.

J. Late 00/Early 01 Prop-Up

In late 00/early 01, Enron's financial results began to come under scrutiny from a few accounting sleuths and short-sellers, who began to question the quality of Enron's reported financial results. While Enron, its top insiders and its bankers assured investors of the correctness of Enron's accounting and the high quality of Enron's reported earnings, the success and strength of its business and its solid prospects for continued strong profit growth, in part because of this increasing controversy, Enron's stock began to decline. As this price decline accelerated, it put pressure on Enron's top executives to do something – anything – to halt the decline in the price of the stock as they knew that if that price decline continued and the stock fell to lower levels, more and more of the Enron stock "triggers" contained in agreements for deals with entities controlled by LJM2 would be triggered, which would require Enron to issue over 100 million shares of its common stock to those partnerships, causing a huge reduction in Enron's shareholders' equity. ¶52.

In late 3/01, inside Enron it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect a shortfall in credit capacity of the LJM2-financed Raptor SPEs, which would have been catastrophic and exposed the scheme. Rather than take that loss and face those consequences, Enron "restructured" the LJM2-financed Raptor vehicles by transferring more than $800 million of contracts to receive Enron's own stock to them just before quarter-end, which permitted the participants in the scheme to conceal substantial losses in Enron's merchant investments, keep billions of dollars of debt off Enron's balance sheet and allowed the Enron Ponzi scheme to continue. ¶53.

During early 01, Enron continued to report record results and it and its bankers continued to make very positive statements (¶54):

- Enron's strong results reflected breakout performance in all business units. Enron was a strong unified business.
- WEOS had strong growth and a tremendous market franchise with significant sustainable competitive advantages.
- EBS intermediation was great. Broadband glut and lowered prices would help Enron.
- VOD was successfully tested and launched. Proven technology created enormous opportunities.
- All of Enron's businesses were generating high levels of earnings. Fundamentals were improving. Enron was very optimistic. Enron was confident growth was sustainable for years to come.

K. The Impending Collapse

By Summer 01, Enron's top insiders realized that Enron would not be able to continue to sustain the illusion of strong profitable growth much longer and that it would have to take large write-offs in the second half of 01 that, in turn, could result in a downgrade of Enron's critical investment grade credit rating – an event that they knew would mean that debt on the books of the SPEs Enron did business with (and partnerships controlled by them), which debt Enron had assured investors was "non-recourse" to Enron would, in fact, become Enron's obligation. ¶55.

On 8/14/01, Enron announced that Skilling – who had become Enron's CEO just months earlier – was resigning, for "personal reasons." While this resignation fanned the controversy over the true nature of Enron's finances and the condition of Enron's business, Enron and its banks lied to investors, telling them that Skilling's resignation was only for personal reasons and did not raise "any accounting or business issues of any kind," and that Enron's financial condition "had never been stronger" and its "future had never been brighter." They said there was "nothing to disclose," Enron's "numbers look good," there were "no problems" or "accounting issues." According to them, the Enron "machine was in top shape and continues to roll on – Enron's the best of the best." ¶57.

L. The End

By 8/01, Enron management employees were complaining to Enron's Board that the fraud at Enron was so widespread it was out of control. In 8/01, two employees complained to the Board (¶59):

(a) One employee wrote:

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

* * *

We have recognized over $550 million of fair value gains on stock via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm. The New Power Co. by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals.... [T]he business world will consider the past successes as nothing but an elaborate accounting hoax....

[W]e booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse. We are under too much scrutiny and there are probably one or two disgruntled "redeployed" employees who know enough about the "funny" accounting to get us in trouble.

* * *

I realize that we have had a lot of smart people looking at this .... None of that will protect Enron if these transactions are ever disclosed in the bright light of day....

* * *

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

* * *

3. There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly....

   a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. He complained mightily to Jeff Skilling ... 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets ....

   b. Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.

   c. I have heard one manager level employee ... say "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company...." Many similar comments are made when you ask about these deals....

   (b) A second employee wrote:

One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrong doings of the various management teams at Enron. However ... I'm sure the board has only scratched the surface of the impending problems that plague Enron at the moment. (i.e., EES's ... hiding losses/SEC violations ... lack of product, etc.).

* * *

[I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked. (JC Penney being a $60MM loss alone, then Safeway, Albertson's, GAP, etc.). Some customers threatened to sue if EES didn't close the deal with a loss (Simon Properties – $8MM loss day one).... Overnight the product offerings evaporated.... Starwood is also mad since EES has not invested the $45MM in equipment under the agreement.... Now you will loose [sic] at least $45MM on the deal.... You should also check on the Safeway contract, Albertson's, IBM and the California contracts that are being negotiated.... It will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion....

This is when they decided to merge the EES risk group with Wholesale to hide the $500MM in losses that EES was experiencing. But somehow EES, to everyone's amazement, reported earnings for the 2nd quarter. According to FAS 131 – Statement of Financial Accounting Standards (SFAS) #131, "Disclosures about Segments of an Enterprise and related information," EES has knowingly misrepresented EES' earnings. This is common knowledge among all the EES employees, and is actually joked about....

There are numerous operational problems with all the accounts.

* * *

... Some would say the house of cards are falling....

You are potentially facing Shareholder lawsuits, Employee lawsuits ... Heat from the Analysts and newspapers. The market has lost all confidence, and its obvious why.

You, the board have a big task at hand. You have to decide the moral, or ethical things to do, to right the wrongs of your various management teams.

* * *

... But all of the problems I have mentioned, they are very much common knowledge to hundreds of EES employees, past and present

Despite receiving these detailed accounts of fraud throughout Enron, Enron's Board did not take any positive action to investigate or to disclose these issues. Instead, Vinson & Elkins – which had participated in many of the fraudulent transactions – was brought in to cover up the wrongdoing so the scheme could continue, which Vinson & Elkins did by writing a whitewash report dismissing these detailed accounts of fraud, even though Vinson & Elkins knew them to be true. ¶60.

On 10/16/01, Enron shocked the markets with revelations of $1.0 billion in charges and a reduction of shareholders' equity by $1.2 billion. Within days, *The Wall Street Journal* began an exposé of the LJM SPEs, the SEC announced an investigation of Enron, and Fastow "resigned." In 11/01, Enron was forced to admit that Chewco had never satisfied the SPE accounting rules and – because JEDI's non-consolidation depended on Chewco's status – neither did JEDI, and Enron consolidated Chewco and JEDI retroactive to 97. This retroactive consolidation resulted in a massive reduction in Enron's reported net income and massive increase in its reported debt. Enron then revealed that it was restating its 97, 98, 99 and 00 financial results to eliminate $600 million in previously reported profits and approximately $1.2 billion in shareholders' equity as detailed below (¶61):

ENRON ACCOUNTING RESTATEMENTS				
	1997	**1998**	**1999**	**2000**
Recurring Net Income Amount of Overstatement	$96,000,000	$113,000,000	$250,000,000	$132,000,000

Debt Amount of Understatement	$711,000,000	$561,000,000	$685,000,000	$628,000,000
Shareholders' Equity Amount of Overstatement	$313,000,000	$448,000,000	$833,000,000	$1,208,000,000

These partnerships – Chewco, LJM and LJM2 – were used by Enron and its management to enter into transactions that Enron could not, or would not, do with unrelated commercial entities. The Outside Directors knew this and were regularly given updates and reports on all three of these entities. The significant transactions were designed to create phony profits or to improperly offset losses. These transactions allowed Enron to conceal from the market very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged – that is, that a third party was obligated to pay Enron the amount of those losses, when in fact that third party was simply an entity in which only Enron had a substantial economic stake. The Raptors transactions alone resulted in Enron reporting earnings from the 3rdQ 00 through the 3rdQ 01 that were almost $1 billion higher than should have been reported! ¶62. Notwithstanding the write-offs and restatement revelations of 10/01-11/01, Enron, J.P. Morgan and CitiGroup believed that they could limit their legal exposure for participation in the scheme if they could sell Enron to another company. So, in 11/01, as the Enron scheme began to unravel, Enron tried desperately to arrange a salvation merger with Dynegy to avoid insolvency of Enron and the inevitable investigations and revelations that would follow such insolvency. ¶64. However, the due diligence efforts of Dynegy uncovered that the true financial condition of Enron was far worse than had been disclosed publicly and that Enron had been engaged in a wide-ranging falsification of its financial statements over the several prior years. Thus, Dynegy refused to acquire Enron. By 11/28/01, Enron's publicly traded debt had been downgraded to "junk" status and on 12/2/01, Enron filed for bankruptcy – the largest bankruptcy in history. Enron's common and preferred stock have become virtually worthless and its publicly traded debt securities have suffered massive price declines, inflicting billions of dollars of losses on purchasers of those securities. ¶66. As *Newsweek* has written (¶69):

> In the late 1990s, by my count, Enron lost about $2 billion on telecom capacity, $2 billion in water investments, $2 billion in a Brazilian utility and $1 billion on a

> controversial electricity plant in India. Enron's debt was soaring. If these harsh truths became obvious to outsiders, Enron's stock price would get clobbered – and a rising stock price was the company's be-all and end-all. Worse, what few people knew was that Enron had engaged in billions of dollars of off-balance-sheet deals that would come back to haunt the company if its stock price fell.

Newsweek, 1/21/02.

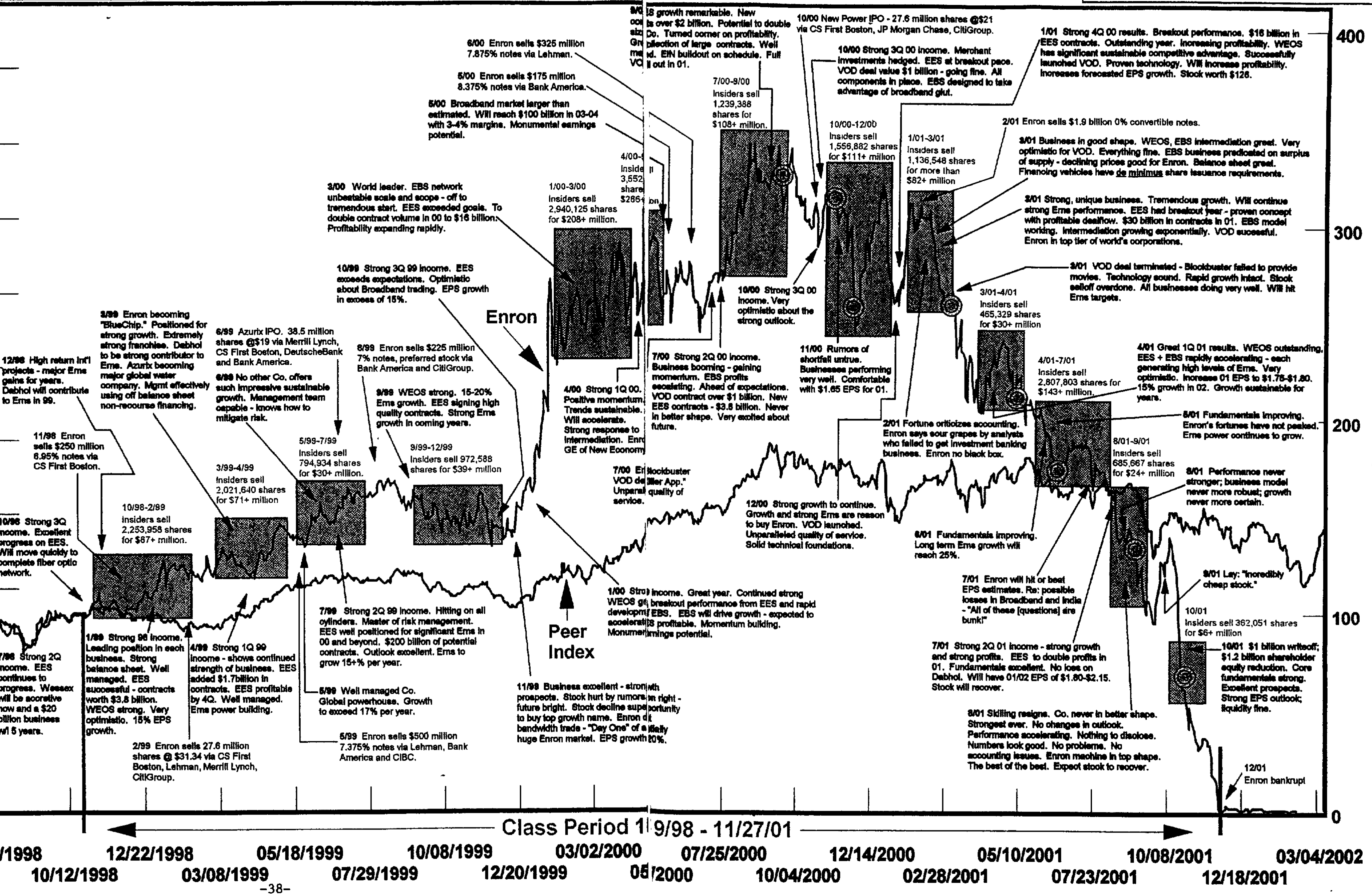
> The key to the Enron mess is that the company was allowed to give misleading financial information to the world for years. Those fictional figures, showing nicely rising profits, enable Enron to become the nation's seventh largest company, with $100 billion of annual revenues. Once accurate numbers started coming out in October, thanks to pressure from stockholders, lenders and the previously quiescent SEC, Enron was bankrupt in six weeks. The bottom line: we have to change the rules to make companies deathly afraid of producing dishonest numbers, and we have to make accountants mortally afraid of certifying them. Anything else is window dressing.

Newsweek, 1/28/02. The rise and demise of Enron is graphically displayed below:

Total Shares Sold By Defendants: 20,788,957 shares
Defendants' Insider Trading Proceeds: $1,190,479,472

Enron Timeline 7/1/98 - 3/7/02

Enron Stock Issuance Price Trigger



M. The Actual Knowledge of the Outside Directors

The details below are compiled from the minutes of certain meetings of the Enron Board or its Executive, Finance or Audit Committees. This information dramatically demonstrates the knowledge, involvement and participation of the Outside Directors in the Enron scheme and their knowledge of the falsity of the statements they made during the Class Period:

- 11/5/97 Executive Committee: Committee recommends that the Board approve the formation of Chewco and JEDI2, and that Enron would provide a bridge loan of $383 million and a guaranty of a $250 million loan to Chewco, which CFO Fastow managed.[6]

  Present at the 11/5/97 Finance Committee meeting were: ***John Duncan, Belfer, Foy, Lay, LeMaistre, Skilling, Winokur,*** Kopper, Derrick, Fastow, Grathman, Kean, Koenig, Shapiro, White, Menchaca.

- 2/7/99 Audit Committee: Arthur Andersen informs the Committee that the accounting in many of Enron's core business areas are high risk and highly judgmental.[7] Present at this meeting were: ***Chan, Foy, Gramm, Jaedicke, and Wakeham.***

- 10/11/99 Finance Committee: Fastow gives committee a report about LJM1 and presents a proposal for the formation of LJM2; committee recommends that full Board waive Fastow's conflict of interest.[8]

> Mr. Fastow reviewed the Company's key financial ratios and long-term liability analysis, noting the mix between fixed and floating rate liabilities and ***on-balance and off-balance sheet debt.... He reviewed the investments made year-to-date by each business unit and compared them to the plan amount***. He discussed the status of capital commitments year-to-date and commented on the transactions the Company had taken or would be taking to fund the cash outflows and noted the importance of funds flow to the Credit Rating Agencies....
>
> ***Mr. Fastow then updated the Committee on a financing structure approved earlier in the year, LJM 1***, and discussed the benefits that the Company had incurred since the transaction closed on June 30, 1999. ***He recommended that the Company continue to syndicate capital investments to address the funds flow issue***. He presented information concerning an unaffiliated investment partnership, LJM2 and discussed the rationale and benefits of the proposed partnership. ***He stated that the partnership could possibly provide the Company with an alternative, optional source of private equity to manage an investment portfolio risk, funds flow, and financial flexibility***. He noted that he would be acting as managing partner of LJM2 and discussed his role in the LJM 2 partnership and how it would benefit the Company. .. He stated that the Audit and Compliance Committee would, on an annual basis, review all transactions completed within the past

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6 Ex. 21.

7 Exs. 16, 22.

8 Ex. 23.

year and make any recommendations they deemed appropriate. He noted that the ***Company's Conduct of Business Affairs Policies (relating to investments and outside business interests of officers and employees) would prohibit him from participating in LJM2 as managing partner due to his position as Executive Vice President and Chief Financial Officer of the Company***, absent appropriate reviews and waivers from the Board and a finding that such participation does not adversely affect the best interests of the Company. He asked that the Committee recommend to the Board that such review and findings be made in this instance to allow his participation. ***Messrs. Causey, Fastow, and Skilling answered questions from the Committee concerning the role of other partners, the review by Arthur Andersen LLP, and the benefits to the Company, which included having another potential buyer of assets and provider of capital, of having Mr. Fastow act as managing partner***.

Present at this meeting were: ***Winokur, Belfer, Blake, Meyer, Urquhart***, Harrison, Lay, ***LeMaistre***, Skilling, Buy, Causey, Fastow, Gorte, Koenig, McMahon, Murphy, Sutton, Carter.

- 10/11-12/99 Full Board: Board gets a presentation about Enron's proposed use of LJM2 to finance and trade with Enron. Full Board approves LJM2 setup and waives Fastow's conflict of interest.[9]

Mr. Winokur then discussed information concerning an unaffiliated investment partnership, LJM 2, and stated that ***the partnership could possibly provide the Company with an alternative, optional source of private equity to manage its investment portfolio risk, funds flow, and financial flexibility***. He noted that Mr. Andrew S. Fastow would be acting as the managing partner of LJM 2 and discussed Mr. Fastow's role in the LJM 2 partnership.... He stated that ***the Company's Conduct of Business Affairs Policies (relating to investments and outside business interests of officers and employees) would prohibit Mr. Fastow from participating in LJM 2 as managing partner due to his position as Executive Vice President and Chief Financial Officer of the Company***, absent appropriate reviews and waivers from the Board and a finding that such participation does not adversely affect the best interests of the Company. He recommended that such review and findings be made in this instance, his motion was duly seconded by Mr. Urquhart, and carried, and the following resolutions were approved:

* * *

WHEREAS, the Partnership, ***as a potential ready purchaser of the Company's businesses and assets or as a potential contract counterparty, could provide liquidity, risk management, and other financial benefits to the Company***:

WHEREAS, the Office of the Chairman of the Company has determined, for the foregoing reasons, that Mr. Fastow's participation as the managing partner/manager of the Partnership will not adversely affect the interests of the Company.

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9 Ex. 24

Present at this meeting and voting to approve the waiver of Fastow's conflict of interest were: ***Lay, Belfer, Blake, Duncan, Foy, Gramm, Harrison, Jaedicke, LeMaistre,*** Mark, ***Mendelsohn, Meyer***, Skilling, ***Urquhart, Wakeham, Winokur***, Causey, Fastow, Koenig, McMahon, Sutton, Carter, ***Pereira, Savage***.

- 5/1/00 Audit Committee: Andersen informs committee of inherently risky accounting areas including structured transactions, merchant portfolio (equity holdings) and inter-company and related party transactions.[10]

> Mr. [David] Duncan discussed the financial reporting areas that AA had determined to be ***high priorities due to inherent risks that were present***. He stated that the ongoing ***high priority areas included structured transactions***, the merchant portfolio, commodity trading activities, project development activities, and ***intercompany, and related party transactions***.

Present at the meeting were: ***Jaedicke, Foy, Gramm, Mendelsohn, Wakeham, Duncan***, Lay, ***LeMaistre***, Skilling, Butts, Buy, Causey, Derrick, Murphy, Sutton, Carter. AA Partners: Bauer, David Duncan, Goddard.

- 5/1/00 Finance Committee: Committee hears of Enron's need for more borrowing to finance its operations. It approves Glisan to replace McMahon who, according to Sherron Watkins, complained to Skilling about accounting improprieties. Fastow gives a report on LJM2's transactions with Enron. Glisan gives a full report on the Raptors, including the fact that Enron has capitalized these purported hedge counterparties with Enron stock.[11]

> Mr. Fastow then gave the Committee an update on LJM2 transactions with the Company including the level of capital commitments, number of investors, number and dollar value of investments already completed, and the Company's business units that had transacted with LJM2. He commented on the direct and indirect impact of LJM1 and LJM2 ("the investment vehicles") on the Company's earnings and funds flow. He stated that he had hired individuals to manage the investment vehicles and that he personally was devoting approximately three hours a week to the investment vehicles. He then called upon Mr. Glisan to discuss Project Raptor.
>
> Mr. Glisan stated that Project Raptor involved establishing a risk management program to enable the Company to hedge the profit and loss volatility of the Company's investments.

Present at the meeting were ***Winokur, Belfer, Blake, Savage***, ***Duncan***, Harrison, Lay, Skilling, Buy, Causey, Fastow, Glisan, Gorte, Koenig, Murphy, McMahon, Sutton, Carter

- 10/6/00 Finance Committee: Fastow tells committee that Enron's cost of capital is 17.17%! Enron needs to finance or syndicate projects that return less than 17.17%. Fastow proposes forming LJM3 and gives a detailed report about how he negotiates with Enron on behalf of LJM2. Skilling reports about financial and operational problems of EES.[12]

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10 Ex. 26.

11 *Id.*

12 Ex. 27.

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- Committee receives a document from Andersen informing the committee that structured finance transactions are at high risk because of significant judgments, and that the use of mark-to-market accounting for new products presents "challenges."[13]

> [Fastow] stated that ***if a project's expected returns were lower than the Company's weighted average cost of capital of 17.17%***, then additional syndication or leverage would be necessary.
>
> Mr. Fastow then discussed the Company's private equity strategy and noted that ***there would be continued significant capital investments by the Company, some of which would not generate cash flow or earnings for a number of years***. He stated that this would necessitate syndication of capital investments if the Company were to continue to grow. He discussed the Company's current total assets and the total assets when unconsolidated affiliates were included. He then noted that management was proposing transacting with a new private equity fund, LJM3, and discussed the Company's rationale for transacting with the fund. He reviewed LJM1 and LJM2, equity funds previously approved by the Board that the Company was already transacting with, and noted the dates of formation, the amount of equity in the funds, and the projects that the funds had invested in. ***He then discussed how his role in the LJM funds could potentially create a conflict of interest in that he negotiates for the LJM funds when they are making investments in the Company's transactions/business***, he receives value from the LJM funds if they perform well, and he must allocate a certain amount of his time to the funds. He then discussed the mechanisms that had been put in place to mitigate any potential conflicts including: 1) his fiduciary responsibilities to the Company, 2) the Office of the Chairman or the Board could ask him to resign from the LJM funds at any time, ***3) Messrs. Buy, Causey, and Skilling approve all transactions between the Company and the LJM funds***, 4) there is an annual Audit and Compliance Committee review of the Company's transactions with the LJM funds, 5) a review of his economic interest in the Company and the LJM funds is presented to Mr. Skilling, and 6) there is no obligation for the Company to transact with the LJM funds.
>
> ***Messrs. Causey and Skilling then discussed the benefits to the Company of having the ability to transact with the LJM funds and Mr. Fastow discussed the other investors in the LJM funds.... Mr. Winokur proposed that the Compensation and Management Development Committee review the compensation received by Mr. Fastow from the LJM funds and the Company***.
>
> * * *
>
> ***[Glisan] discussed the Company's guarantee portfolio and stated that the significant increase in the volumes transacted by the Company had led to related increases in required guarantees***.
>
> * * *
>
> [Buy] presented a chart depicting the capital expenditures made or projected to be made by EES and stated that improvements have been made in

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13 *Id*

developing projects but that ***actual project implementation was lagging behind the original projections***. Mr. Skilling joined him in answering questions from the Committee regarding EES's capital expenditures and the ***potential implication of the slowdown in project implementation on future earnings***.

Present at the meeting were: ***Winokur, Belfer, Blake, Chan, Meyer, Pereira, Savage, Urquhart, Duncan***, Gramm, ***LeMaistre, Mendelsohn***, Skilling, Buy, Causey, Fastow, Glisan, Gorte, Koenig, Murphy, Sutton, Carter.

III. Argument

A. Plaintiffs Meet the Applicable Pleading Standard

A motion to dismiss must be denied unless it appears beyond doubt that the plaintiff can prove no set of facts upon which the court can grant relief. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Kaiser Aluminum & Chemical Sales, Inc. v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982) (citing Wright & Miller, *Federal Practice and Procedure: Civil* §1357 at 598 (1969), for the proposition that "'the motion to dismiss for failure to state a claim is viewed with disfavor and is rarely granted'"); *In re Landry's Seafood Restaurants, Inc. Sec. Litig.*, Civ. No. H-99-1948, slip op. at 4 n.8 (S.D. Tex. Feb. 20, 2001). "In the securities context, Rule 12(b)(6) dismissals are difficult to obtain because the cause of action deals primarily with fact-specific inquiries." *Haack v. Max Internet Communs., Inc.*, No. 3:00-CV-1662-G, 2002 U.S. Dist. LEXIS 5652, at *11 (N.D. Tex. Apr. 2, 2002) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988)).

In determining a motion to dismiss, the court must "accept as true all well-pleaded allegations in the complaint and ... construe those allegations in the light most favorable to the plaintiff." *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 406 (5th Cir. 2001) ("we will accept the facts alleged in the complaint as true and construe the allegations in the light most favorable to the plaintiff"); *Scheuer v. Rhodes*, 416 U.S. 232 (1974), *Landry's*, slip op. at 4 n.8 ("In reviewing the sufficiency of a complaint in response to a motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b) (6) ... the district court should consider all allegations in favor of the plaintiff and accept as true all well-pleaded facts in the complaint.").

Finally, the court should consider the allegations in their entirety. *STI Classic Fund v. Bollinger Indus., Inc.*, No. 3-96-CV-823-R, 1996 U.S. Dist. LEXIS 21553, at *5 (N.D. Tex. Oct. 25,

1996) (it is improper to isolate "the circumstances alleged in Plaintiffs' amended complaint rather than to consider them in their totality").

When reviewing a complaint's sufficiency at the motion to dismiss stage, the Fifth Circuit has held a court may take judicial notice of public filings, documents referred to or partially quoted in the complaint, and documents of public record.

> When deciding a motion to dismiss a claim for securities fraud on the pleadings, a court may consider the contents of relevant public disclosure documents which (1) are required to be filed with the SEC, and (2) are actually filed with the SEC. Such documents should be considered only for the purpose of determining what statements the documents contain, ***not to prove the truth of the documents' contents***.

Lovelace v. Software Spectrum Inc., 78 F.3d 1015, 1017-18 (5th Cir. 1996). *Accord In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 881-82 (S.D. Tex. 2001) (same).

Documents that have recently become part of the public record, including Congressional testimony and Enron-related documents furnished to Congress, are "'pertinent,' 'central,' or 'integral to [Plaintiffs'] claim,'" *BMC Software*, 183 F. Supp. 2d at 883, and are thus annexed to and incorporated in plaintiffs' opposition.[14] These documents are minutes of certain meetings of Enron's Board and its committees that pertain to the central allegations in the CC. Defendants are on notice of these documents because the transactions the Board approved at these meetings are described in detail throughout the CC, and the CC alleges that the directors were aware of, approved, and failed to correct these acts of fraud. *See*, *e.g.*, ¶¶60, 395. Moreover, defendants acknowledge notice of these documents in their technical pleading challenge to the CC: "It is telling that under the unique circumstances of this case, with thousands of documents already in the public domain, daily investigative newspaper reports, frequent congressional hearings, testimony from key witnesses, and countless ongoing investigations, all of which were available to Plaintiffs in preparing their complaint, the particularized allegations against the individual Outside Directors are few, superficial, and wholly lacking in ***any*** facts showing fraudulent intent on their part." Outside Dir. Br. at 49.

Implicit in this argument is the admission that the Outside Directors' motion does not claim that plaintiffs' case is frivolous or lacks merit, but seeks refuge in what it believes to be an

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[14] Here, as elsewhere, emphasis is added and citations and footnotes omitted unless otherwise noted.

insurmountable pleading standard. If a small part of the CC and the public information defendants refer to were accepted as true, the case for fraud is overwhelming. Defendants' statement also implicitly acknowledges the enormous volume of public record documents and the impracticality of listing or citing these documents, let alone attaching them.

Finally, this limited selection of documents will allow the Court to evaluate efficiently the superficial nature of defendants' arguments in the context of the publicly known facts of this case. Indeed, in their opposition papers, defendants relied upon (and annexed) a variety of news reports, Defs' Jt. Discl. Brf. at 235-44 (citing *BMC Software*), and referred to and relied upon defendants' Congressional testimony. *See* Outside Dir. Br. at n.3

B. The CC Satisfies the Particularity Pleading Requirements of Rule 9(b) and the PSLRA

Rule 9(b) provides that "[i]n all averments of fraud ... the circumstance constituting fraud ... shall be stated with particularity." Fed. R. Civ P. 9(b). The rule, however, does ***not*** require the pleading of evidence – let alone conclusive proof – of defendants' fraudulent conduct. *ABC Arbitrage v. Tchuruk*, Civ. No. 01-40645, 2002 U.S. App. LEXIS 9112, at *35 n.70 (5th Cir. May 13, 2002) ("even when the requirements of Rule 9(b) are combined with the requirements of 15 U.S.C. §78u-4(b)(1) under the PSLRA, the plaintiff need not plead '***all*** his evidence' related to a securities fraud claim") (emphasis in original); *In re NetSolve, Inc.*, 185 F. Supp. 2d 684, 696 n.10 (W.D. Tex. 2001) ("At the motion to dismiss stage, the plaintiffs need only ***allege*** facts sufficient to describe the purported fraud with the requisite particularity.") (emphasis in original); *Scheiner v. i2 Technologies, Inc.*, Civ. No. 3:01-CV-418-H, bench op. at 3 (N.D. Tex. Apr. 11, 2002) ("What has to be stated in a complaint by the plaintiffs is facts sufficient or specific facts set forth which are sufficient to support an allegation, ***and not all the facts***...."); *Chartwell Healthcare v. People's Home Health*, No. 3:96-CV-1938-G, 1997 U.S. Dist. LEXIS 4659, at *6 (N D. Tex Feb. 19, 1997) (factual statements "addressing the 'who, what, when, where, and how' of defendants' alleged securities fraud" satisfy the pleading requirements of Rule 9(b)).

Rather, plaintiffs are required only to "put the defendants on notice of the claims and to allow them to frame responsive pleadings" by "addressing the 'who, what, when, where, and how' of defendants' alleged securities fraud." *Id.*; *accord Rubinstein*, 20 F.3d at 163; *Berger v. Compaq*, Civ A. No. H-98-1148, slip op. at 16 (S.D. Tex. Dec. 22, 1999); *In re Compaq Sec. Litig.*, 848 F. Supp. 1307, 1310 (S.D. Tex. 1993) ("Since Rule 9(b) is to be read in conjunction with Rule 8's general notice pleading requirement that pleadings contain a 'short and plain statement of the claim,' it can be satisfied as long as the complaint contains information concerning the 'time, place, and nature of fraudulent behavior and defendant's relationship thereto.'"); *Steiner v. Southmark Corp.*, 734 F. Supp. 269, 274 (N.D. Tex. 1990) ("Plaintiffs' complaints apprise [defendant] of the time, place, and nature of alleged fraudulent behavior and [defendant's] relationship thereto. Rule 9(b) requires no more.").

Similar to Rule 9(b), the PSLRA provides that a §10(b) complaint must "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." 15 U.S.C. §78u-4(b)(1). The Fifth Circuit has recognized that the pleading requirements contained in the PSLRA are merely an adoption of the "particularity" requirements of Rule 9(b). *See ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *29-*30 & n. 60 ("We have held that, pursuant to Rule 9(b), 'articulating the elements of fraud with particularity requires a plaintiff to specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent,' which is, as we have stated in dicta, 'the same standard' required by the PSLRA under 15 U.S.C. §78u-4(b)(1)."); *Williams v. WMX Techs.*, 112 F.3d 175, 178 (5th Cir. 1997); *McNamara v. Bre-X Minerals, Ltd.*, 57 F. Supp. 2d 396, 405-06 (E.D. Tex. 1999).

The Fifth Circuit recently noted that the PSLRA was enacted to prevent abusive frivolous strike suits, and "was ***not*** enacted to raise the pleading burdens under Rule 9(b) and section 78u-4(b)(1) to such a level that facially valid claims, which are not brought for nuisance value or as leverage to obtain a favorable or inflated settlement, must be routinely dismissed on Rule 9(b) and 12(b)(6) motions." *ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *44. Moreover, the Fifth Circuit explained that, "[a]s one district court in this circuit has recently noted, 'the plaintiffs need not allege "all" facts that may be "related" to their claims,' since 'such a requirement is impossible at the pleading stage because, in nearly every securities fraud case, only the defendants know 'all' the facts." *Id.*

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Here, plaintiffs have satisfied the requirements of particularized pleading, as the CC identifies each of the statements alleged to be materially false and misleading. The CC also specifies who made the statements, when and where the statements were made, and why the statements were false. Indeed, plaintiffs have gone well beyond the pleading requirements and set forth evidence establishing the falsity of the challenged statements.

The Outside Directors' contention that the CC is insufficiently specific primarily consists of false, generalized accusations of non-specificity, of claims that each of the Outside Directors is named in only a few paragraphs of the CC, *see* Outside Dir. Br. §I.(A, C), that plaintiffs rely on the group pleading doctrine, or that there is not enough information leveled specifically at each defendant. Defendants argue that plaintiffs failed to specify every imaginable detail. Yet, the requirements of Rule 9(b) and the PSLRA have been satisfied, and the Fifth Circuit has made it clear that alleging ***all*** facts that may be related to plaintiffs' claims is not only ***not*** required (inasmuch as only ***sufficient*** facts need be alleged), but is also an ***impossibility*** as the facts are within defendants' knowledge. *ABC Arbitrage*, 2002 U.S. App. Dist. LEXIS 9112, at *44.

Notably, the group pleading cases the Outside Directors cite (*BMC Software*, 183 F. Supp 2d at 913 n.50; *Coates v. Heartland Wireless Communs., Inc.*, 26 F. Supp. 2d 910, 916 (N.D. Tex. 1998); and *Allison v. Brooktree Corp.*, 999 F. Supp. 1342, 1350 (S.D. Cal. 1998)), only held inapplicable the traditional "group published presumption" that company statements in annual reports, press releases, and the like "may be presumed to be the collective work of ***those individuals with direct involvement in the everyday business*** of the company." *BMC Software*, 183 F. Supp. 2d at 913 n.50; *Coates*, 26 F. Supp. 2d at 915; *Allison*, 999 F. Supp. at 1350-51 ("group published doctrine 'is grounded in reasonableness'"; particular non-signing defendants dismissed without prejudice and with leave to amend due to need for "additional allegations demonstrating the reasonableness of applying the presumption to these defendants"). Thus, this Court's and some other courts' conclusion that the PSLRA eliminated the group pleading presumption is of no help to those defendants who actually ***made, signed or otherwise participated*** in misleading statements or transactions

The CC specifies precisely what statements each Outside Director made, and when, and where they were issued. ¶¶141, 221, 292, 1006. The statements of the Outside Directors alleged to be false are the annual reports and the various registration statements that each of the Outside Directors individually signed. The Ninth Circuit in *Howard v. Everex Sys.*, 228 F.3d 1057 (9th Cir. 2000), held that an officer who signed financial statements filed with the SEC actually ***made*** the statements as a primary violator, and that a complaint pleading such statements, with scienter, satisfied the particularity requirements of Rule 9(b) and the PSLRA: "[W]hen a corporate officer signs a document on behalf of a corporation, that signature will be rendered meaningless unless the officer believes that the statements in the document are true." *Id.* at 1061; *see also AUSA Life Ins. Co. v. Dwyer (In re JWP Inc. Sec. Litig.)*, 928 F. Supp. 1239 (S.D.N.Y. 1996) (rejecting group pleading yet holding directors on audit committee who signed 10-Ks liable as primary violators of 10-b for false and misleading statements in the 10-Ks, and attached documents). Thus the CC, which pleads that the Outside Directors actually signed 10-Ks containing false financial information, does not rely on the group pleading doctrine, as the Outside Directors argue.

There is no dispute that Enron's financial statements during the Class Period were false. Enron's restatement admitted to overstating profits by over $591,000,000, understating debt by as much as $711,000,000 and understating shareholders' equity by $1,208,000,000. ¶61. There is also no dispute that each of the moving Outside Directors signed at least one of the 10-Ks containing this false information, and that most of the Outside Directors signed all four. ¶¶141, 221, 292. Therefore, the movants' statement that "[n]owhere in the complaint do Plaintiffs even attempt to identify any particular false statement or omission in Enron's public filings," Outside Dir. Br. at 8, is perplexing and obviously untrue.

Moreover, the Outside Directors ignore the well-settled principle that the Court must read the CC ***as a whole***, and that "it is wrong to treat each individual piece of information separately, as if it had no relation to the other pieces which surround it." *Isquith v. Middle S. Utilities*, 847 F.2d 186, 201 n.9 (5th Cir. 1988). Plaintiffs' allegation of specific, contemporaneous, inter-related facts that caused defendants' statements to be false and misleading are set forth throughout the CC and more than adequately serve to particularize the statements claimed to have been false and misleading.

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Listed below are the 10-Ks and Registration Statements filed during the Class Period and the individual Outside Directors who signed them.

Date	Statement	Outside Director Signed
3/98	Enron's 97 10-K (¶¶109, 510).	Belfer, Blake, Chan, John Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Urquhart, Wakeham, Walker and Winokur
4/21/98	Registration Statement incorporated the 97 10-K, as well as Enron's 1stQ 98 results (¶110).	Belfer, Blake, Chan, John Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Urquhart, Wakeham, Walker and Winokur
1/12/99	Registration Statement for $1 billion in Enron securities (¶126).	Belfer, Blake, Chan, John Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Urquhart, Wakeham, Walker and Winokur
2/3/99	Registration Statement incorporated Enron's 98 financial results (¶134).	Belfer, Blake, Chan, John Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Urquhart, Wakeham, Walker and Winokur
3/99	Enron's 98 10-K containing 97 and 98 financial statements (¶¶136-141, 510).	Belfer, Blake, Chan, John Duncan, Foy, Gramm, Jaedicke, LeMaistre, Meyer, Urquhart, Wakeham, Walker and Winokur
7/23/99	Form S-3 for Enron Notes that incorporated the 98 10-K and the 2ndQ 99 10-Q (¶¶164, 513, 515, 612).	Belfer, Blake, Chan, John Duncan, Foy, Gramm, Jaedicke, LeMaistre, Mendelsohn, Meyer, Urquhart, Wakeham and Winokur
8/10/99	Form S-3 for Enron Notes that incorporated the 2ndQ 99 results (¶165).	Belfer, Blake, Chan, Duncan, Foy, Gramm, Jaedicke, LeMaistre, Mendelsohn, Meyer, Urquhart, Wakeham and Winokur

Date	Statement	Outside Director Signed
3/00	Enron's 99 10-K containing 98 and 99 financial statements ¶(221).	Belfer, Blake, Chan, John Duncan, Mendelsohn, Meyer, Pereira, Savage, Urquhart, Wakeham and Winokur
3/01	Enron's 00 10-K containing 99 and 00 financial statements (¶¶292-298, 510, 636-639).	Belfer, Blake, Chan, John Duncan, Gramm, Jaedicke, LeMaistre, Mendelsohn, Meyer, Pereira, Savage, Urquhart, Wakeham and Winokur
7/13/01	Form S-3 filed to register $1.9 billion of Enron notes that incorporated the 00 10-K (¶336).	Belfer, Blake, Chan, John Duncan, Gramm, Jaedicke, LeMaistre, Mendelsohn, Pereira, Savage, Wakeham and Winokur

In summary, the Outside Directors' brief also ignores the hundreds of paragraphs of the CC that explain exactly why Enron's financial statements were false. *See* ¶¶418-641. Among these reasons.

- Enron's financial statements violated GAAP. ¶¶610-611.
- Enron inflated revenues and profits via SPEs that traded assets and derivatives with Enron. ¶¶10-11, 21, 23, 26-28(a), 32, 66.
- Enron recognized revenues improperly by trading with related entities that should have been consolidated. *Id.* ¶¶442-447, 450, 466-472.
- Enron improperly recognized revenue from the appreciation of its own stock. ¶¶42, 59, 445-446, 454-456, 462, 477, 929, 952(a).
- Enron inflated its revenue and profits by using false hedges with the Raptors and other SPEs that it knew were not creditworthy enough to make good on their hedge obligation. ¶¶33-35, 42, 155, 300(p), 462-465, 477-488.
- Enron disguised loans as commodity trades with entities like Mahonia and Delta. ¶¶44-47, 559-564, 565-568.
- Enron falsified transactions to hide debt, and keep recourse debt of its books, with entities like Chewco (¶¶8-11, 22, 435-447) LJM and LJM2 (¶¶23-28, 32, 448-495), and in deals like the Nowa Sarznya Power Plant (¶¶28(b), 471), MEGS, LLC (¶¶28(c), 472), Yosemite (¶¶28(d), 473-474), and the Connecticut Resources deal (¶¶569-573).
- Enron hid expenses by capitalizing expenses for failed bids and projects, that should have been written off immediately. ¶¶121(f), 155(j), and (k), 580-582.

- Enron hid massive contingent liabilities in violation of GAAP. ¶¶429-505.
- Enron improperly recognized $111 million in a sham deal with Blockbuster named project Braveheart. ¶¶521-526.
- Enron lied about the prospects and viability of its entire Broadband division because it could not and did not have the technology or the customers it said it had. ¶¶39-41, 214(h)-(i), 300(h)-(i), 339(h)-(i), 521-526.
- Enron engaged in fictitious trades of "dark fiber" swaps. ¶¶43, 70(a), 214(j), 300(j), 339(j), 361, 475, 497, 527-529.
- Enron abused mark-to-market accounting in its earnings from Merchant Assets. ¶¶549-556.
- Enron improperly failed to write down the impairment of long-term assets and investments such as Azurix (¶¶590-593), Broadband Services (¶¶594-595), TGS (¶596), New Power (¶597), the Dabhol power plant (¶¶155(h), 598-602), projects in Nicaragua, and Puerto Rico (¶¶603-604), Brazil (¶¶605-606), and the PromiGas project (¶607).
- Enron abused mark-to-market accounting in its commodity trading by "moving-the-curve" forward to recognize immediately future speculative revenue. ¶¶36, 214(g), 300(g), 339(g), 533-539.
- Enron abused mark-to-market accounting by improperly employing this method of revenue recognition to new and untested markets. ¶¶36-38, 121(e), (g), (j), 155 (e)-(g), (o), 214 (e)-(g), 300(e)-(g), 533-539, 546-548.

C. Plaintiffs Have Stated a Claim for Violation of §10(b)

1. The Outside Directors' Misrepresentations and Omissions of Material Fact Are Actionable

a. Plaintiffs Have Adequately Pleaded Claims Under Section 10(b) of the Exchange Act and Satisfied the PSLRA's Standards for Pleading Falsity

To state a claim under §10(b) of the Exchange Act, a plaintiff must allege: (1) that the defendant made a misrepresentation or omission of material fact, (2) in connection with the purchase or sale of a security; (3) with scienter; (4) that the plaintiff relied upon;[15] (5) causing plaintiff to suffer damages. *Basic*, 485 U.S. at 230-32; *WMX Techs*, 112 F.3d at 177; *Berger*, slip op. at 18;

[15] Allegations of individual reliance are not necessary where, as in this case, a fraud-on-the-market is alleged. *See Basic*, 485 U.S. at 241-47; *Robertson v. Strassner*, 32 F. Supp. 2d 443, 448 (S.D. Tex. 1998); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) (omissions).

Robertson, 32 F. Supp. 2d. 443. The CC, read in the light most favorable to plaintiffs, adequately pleads each of these elements and therefore states a claim under §10(b).[16]

The Outsider Directors' misstatements here, which concern the state of Enron's assets and financial affairs, are the ***classic*** type of misstatements which are actionable under the securities laws. *See In re Triton Energy Ltd. Secs. Litig.*, No. 5:98-CV-256, 2001 U.S. Dist. LEXIS 5920, at *28-*29 (E.D. Tex. Mar. 30, 2001) (as in *Rubinstein*, 20 F.3d at 167-168, plaintiffs' contention that company and its officers made a number of statements inconsistent with the state of company assets, and adopted company worth analyses that were not in accord with company's financial affairs sufficiently alleged misrepresentations).

b. The Outside Directors Are Liable Under Section 10(b) for Failing to Make Full and Accurate Disclosure of All Material Facts

The Supreme Court has stated repeatedly that the fundamental philosophy underlying the federal securities laws is one of complete and accurate disclosure. For example, in *Basic*, 485 U.S. at 230, the Court held:

> "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market thrive upon mystery and secrecy." H.R. Rep. No. 1383, 73d Congress, 2d Sess., 11 (1934). ***This Court "repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure.'"***

(Quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-78 (1977).) Building upon this foundation, courts have recognized that a duty to disclose material facts arises when ***any*** one of the following three tests is satisfied: (1) when a corporate insider trades securities; (2) when a statute or regulation requires such disclosure; ***or*** (3) when a corporation has made "inaccurate, incomplete, or misleading" prior or contemporaneous disclosures. *See Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26-27 (1st Cir. 1987); *Berger*, slip op. at 18.

Plaintiffs have alleged particular facts supporting the Outside Directors' duty to disclose under ***each*** of these three tests. ***First***, because they chose to sell their stock, the Outside Directors

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[16] Plaintiffs assert a §10b claim against Belfer, Blake, Chan, John Duncan, Foy, Gramm, Jaedicke and LeMaistre.

were obligated to inform the public regarding all material matters.[17] ***Second***, securities regulations promulgated by the SEC mandated that the Outside Directors disclose all known material facts that would tend to contradict or qualify their reported financial results.[18] ***Third***, numerous times during the Class Period, the Outside Directors made public statements regarding the financial condition of Enron, including specific statements about Enron's financial condition and revenues. These public statements were positive affirmations of Enron's existing operational and financial condition. Once defendants undertook voluntarily to speak, they had a duty to tell the whole truth. *Rubinstein*, 20 F.3d at 170 ("As we have long held under Rule 10b-5, 'a duty to speak the full truth arises when a defendant undertakes a duty to say anything.' Although such a defendant is under no duty to disclose every fact or assumption underlying a prediction, he must disclose material, firm-specific adverse

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[17] Federal courts have long held that corporate insiders, such as the Outside Directors, in possession of material inside information must either disclose it to the investing public, or, if disabled from disclosing the information to protect a corporate confidence, or they choose not to disclose the information, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc). *See also In re Browning-Ferris Industries Inc. Sec. Litig.*, 876 F. Supp. 870 (S.D Tex. 1995) (corporate insiders wishing to trade when in possession of material non-public information must either disclose information or wait until it has been disclosed in natural course of events before trading); *SEC v. Hoover*, 903 F. Supp. 1135 (S.D. Tex. 1995) (same); *Compaq*, 848 F. Supp. 1307 (same).

[18] The SEC has repeatedly stated that the anti-fraud provisions of the federal securities laws, which are intended to ensure that the investing public is provided with "complete and accurate information about companies whose securities are publicly traded," apply to all public statements by persons speaking on behalf of publicly traded companies "that can reasonably be expected to reach investors and the trading markets, whoever the intended primary audience." SEC Release No. 33-6504, 1984 SEC LEXIS 2559, at *2 (Jan. 13, 1984). The SEC has emphasized that "[i]nvestors have legitimate expectations that public companies are making, and will continue to make, prompt disclosure of significant corporate developments." SEC Release No. 18271, 1981 SEC LEXIS 292, at *13 (Nov. 19, 1981). Furthermore, under Items 303(a) and 303(b) of Regulation S-K, promulgated by the SEC under the Exchange Act, there is a duty to disclose in annual and periodic reports filed with the SEC "known trends or any known demands, commitments, events or uncertainties" that are reasonably likely to have a material impact on a company's sales revenues, income or liquidity, or cause previously reported financial information not to be indicative of future operating results. 17 C.F.R. §229.303(a)(1)-(3) and Instruction 3. While a company is not required to make predictions about its future performance in its public records pursuant to Item 303 of Regulation S-K, the SEC explicitly distinguishes predictions from ***presently known*** data which will impact upon future operating results, which the SEC ***does*** require to be disclosed if material. *See, e.g., In re Caterpillar, Inc.*, SEC Release No 30532, 1992 SEC LEXIS 786, at *15 (Mar. 31, 1992) (a company must provide sufficient information to permit investors to see the company "through the eyes of management").

facts that affect the validity or plausibility of that prediction."). *First Virginia Bankshares v. Benson*, 559 F 2d 1307, 1317 (5th Cir. 1977).

Whether the "full truth" has been disclosed is also a jury question. *First Virginia Bankshares*, 559 F.2d at 1317. *See also Isquith*, 847 F.2d at 208 ("Generally, like materiality, determining whether information has been adequately disclosed is a mixed question of fact and law and, therefore, is a question for a jury.") (vacating lower court's grant of summary judgment).[19]

Here, the Outside Directors' failure to disclose the problems impacting Enron prevented investors from viewing Enron "'through the eyes of management.'" *Caterpillar*, 1992 SEC LEXIS 786, at *15. Defendants were under a duty to disclose this material information. *See Simon v. American Power Conversion Corp.*, 945 F. Supp. 416, 431 (D.R.I. 1996) (10-Q filing imposed affirmative duty on company to disclose related material information).

c. The Outside Directors Who Sold Their Stock Are Liable for Insider Trading Even if They Had Not Made Public Statements

It has been long established that under §10(b), a corporate insider has a duty to disclose material nonpublic information or to abstain from trading on the information. *Chiarella v. United States*, 445 U.S. 222 (1980). A defendant need not have made a false or misleading statement to be liable. A violation of §10(b) and Rule 10b-5 occurs when a corporate insider trades in his corporation's securities based on material, nonpublic information that the insider obtained by reason of his position; such trading qualifies as a "deceptive device" under §10(b). *United States v. O'Hagan*, 521 U.S. 642, 643, 652 (1997) (trading on material, nonpublic information qualifies as a "deceptive device" under §10(b) because "'a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation'" and that relationship "'gives rise to a duty to disclose [or abstain from trading] because of the "necessity of preventing a corporate insider from . . taking

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19 *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1336 (7th Cir. 1995), cited by defendants, only held that plaintiffs ***forfeited*** the right to argue that the defendants' statements were fraudulent when made because plaintiffs failed to present the arguments to the district court on a timely basis. The plaintiffs were permitted to continue pursuing a theory that the defendant had a duty to correct historical statements within a reasonable time.

unfair advantage of .. uninformed ... stockholders""'). Such a relationship of trust exists between shareholders and "officers, directors, and other permanent insiders of a corporation." *Id.* at 652. *See also Dirks v. SEC*, 463 U.S. 646, 654 (1983) (to satisfy the manipulation or deception requirement, an insider will only be liable under Rule 10b-5 when he fails to disclose material nonpublic information before trading on it and makes secret profits).

"[W]hen an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading." *SEC. v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998). In *Adler*, the Eleventh Circuit found that a corporate insider's involvement at a board meeting made it "clear that [the insider] was in possession of whatever information was dispensed at the ... Board meeting." *Id.* at 1339. *See also Ceres Partners v. GEL Assoc.*, 918 F.2d 349, 360 (2d Cir. 1990) (§10(b) and Rule 10b-5 have been held to allow claims of insider trading based on theory of insider's misappropriation of corporate information) (citing *SEC v. Materia*, 745 F.2d 197, 202-03 (2d Cir. 1984)). Defense arguments that there was no causal connection between the information they had and the trades they made are not appropriate at this stage of the litigation but are reserved for the triers of fact. *Adler*, 137 F.3d at 1337, 1339

These defendants were present at board meetings throughout the Class Period in which they received adverse, nonpublic information. ¶¶395, 398. Plaintiffs sufficiently pleaded that material nonpublic information was used by the Outside Directors for their personal advantage in contravention of their duty to disclose or abstain.

2. The Outside Directors' Use of Manipulative and Deceptive Devices Is Actionable

Plaintiffs here have pleaded and are pursuing theories of recovery against the Outside Directors and other defendants that are well-grounded in the ***express language*** of §10(b) of the Exchange Act which states:

> Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly ....
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... ***any manipulative or***

> ***deceptive device or contrivance*** in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[20]

Rule 10b-5 promulgated by the SEC flows directly from the language of §10(b) itself and provides:

> §240.10b-5. Employment of manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Not only does Rule 10b-5 forbid the making of "any untrue statement of a material fact," it also provides for scheme liability. Scheme liability is authorized by the text of §10(b). According to the Supreme Court, §10(b)'s prohibition of "any ***manipulative or deceptive device or contrivance***" necessarily encompasses any "***scheme to defraud***" In *Ernst & Ernst v. Hochfelder*, 425 U S 185 (1976), the Court referred to the dictionary definitions of §10(b)'s words to find that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice.'" *Id.* at 199 n.20 (quoting *Webster's International Dictionary* (2d ed. 1934)). The Court found that a "contrivance" means "'***a scheme, plan, or artifice***.'" *Id.* (quoting *Webster's International Dictionary* (2d ed. 1934)); *see also Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Clearly, "scheme" is encompassed in the broad language of §10(b).

Thus Rule 10b-5 – adopted by the SEC to implement §10(b) – makes it unlawful for any person "***directly or indirectly***" to employ "***any*** device, ***scheme***, or artifice ***to defraud***," "***[t]o make***

[20] Note that §10(b) itself does not expressly prohibit untrue statements of material facts or material omissions. This prohibition, like the prohibition against fraudulent schemes and fraudulent courses of business, is in Rule 10b-5.

any untrue statement[s], " or to "***engage in any act, practice, or course of business which operates ... as a fraud or deceit upon any person.***" 17 C.F.R. §240.10b-5. *See also U.S. Quest, Ltd. v. Kimmons,* 228 F.3d 399, 407 (5th Cir. 2000).

Prior to the Supreme Court's endorsement of the presumption of reliance based on the fraud-on-the-market theory for both misrepresentations and omissions in *Basic Inc.*, the Fifth Circuit had held that the theory applied ***only*** to omission cases and not misrepresentation cases. Thus, in some instances, securities plaintiffs sought recovery under subsections (1) and (3) of Rule 10b-5 alleging ***fraudulent scheme and course of business liability***. The Fifth Circuit expressly recognized the validity of these theories of recovery.

For instance, in *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987), plaintiff sued under §10(b) and Rule 10b-5, claiming that the stock of Docutel was inflated due to false financial reports. According to plaintiff, Olivetti (which owned 46% of Docutel and controlled it) forced Docutel to buy Olivetti's excess inventories at inflated prices so Olivetti could hide losses it was suffering. Docutel concealed this financial manipulation for some time but, when its auditors discovered the financial manipulation and forced a large inventory writedown, huge losses were disclosed and Docutel stock fell. The district court dismissed the complaint against Olivetti and Docutel because plaintiff failed to allege reliance on any of the false statements in Docutel's SEC filings, etc.

> But the fact that the complaint lists a number of documents filed with the SEC does not limit plaintiff's claim to subsection (2) only. For, as in *Shores*, plaintiff's lack of reliance on these documents does not resolve the claims made under 10b-5(1) and (3). ***We find that plaintiff's complaint properly alleges a scheme to defraud or course of business operating as a fraud for purposes of the first and third subsections; plaintiff's complaint, taken as a whole, alleges that Olivetti forced Docutel to take its worthless inventories, that this scheme or course of business was not disclosed, and that the effect was to defraud certain purchasers of Docutel****....*
>
> The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the market place; ***if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3)***. Thus, we conclude that the district court erred in its dismissal of the complaint as to plaintiff's claims under 10b-5(1) and (3).

Id. at 363-64. *Accord Heller v. Am. Indus. Props. Reit*, Civ. No. SA-97-CA-1315-EP, 1998 U.S. Dist. LEXIS 23286, at * 14 (W.D. Tex. Sept. 25, 1998) ("The first and third subsections, on the other hand, ***create a duty not to engage in a fraudulent scheme or course of conduct*** ....").

The Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading offering circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that offering circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme***." *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981).

The fraudulent scheme and course of business involving Enron ***was worldwide in scope, years in duration and unprecedented in scale***, and required the skills and active participation of lawyers, bankers and accountants to help design, implement, conceal and falsely account for the deceptive acts and devices, manipulative and deceptive contrivances and artifices they and Enron were using to falsify Enron's reported profits and financial condition and to continue its fraudulent course of business. The scheme also required the willing participation of Enron's directors because the most egregious actions in the Enron scheme were formally approved by the Enron Board.

The notion that *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), issued a broad edict that protects everyone except corporate officers from liability for their participation in complex securities frauds is nonsense. *Central Bank* expressly recognized: "The absence of §10(b) aiding and abetting liability ***does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity ... who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser ... relies may be liable as a primary violator under 10b-5 .... In any complex securities fraud, moreover, there are likely to be multiple violators***...." *Id.* at 191. A scheme to defraud often will involve a variety of actors, and investors are entitled to allege "***that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme***." *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998); *accord SEC v. First Jersey Secs.*, 101 F.3d 1450, 1471 (2d Cir. 1996); *In re Health Mgmt. Inc. Sec. Litig.*, 970 F. Supp. 192, 209 (E.D.N.Y. 1997); *Adam v. Silicon Valley Bancshares*, 884 F. Supp.

1398, 1401 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 699-70 (C D Cal 1994).

In *Central Bank*, a public building authority issued bonds to finance public improvements. Central Bank served as indenture trustee. The bonds were secured by liens covering property. The bond covenants required that the liened land be worth at least 160% of the principal amount of the bonds. Central Bank got a letter expressing fear that property values were declining and that perhaps the 160% value test was no longer met. The bank did nothing. Soon afterwards, the public building authority defaulted on the bonds. The bonds were not publicly traded. Central Bank, which had no commercial lending relationship with the municipal entity involved and which was not an investment bank, issued no analyst reports about the issuer of the municipal bonds and thus made no statement and took no affirmative act that could have affected the trading price of the municipal bonds in issue. Clearly, the Outside Directors who acted at the epicenter of the fraud, stand in a different position than Central Bank.

The *Central Bank* majority noted that their reasoning was "confirmed" by the fact that if they accepted the plaintiffs' aiding and abetting argument it would impose §10(b) liability "when at least one element critical for recovery" was absent, *i.e.*, reliance 511 U.S. at 180 (citing *Basic*, 485 U.S 224 (the Supreme Court's "***fraud-on-the-market***" decision) for the proposition that a plaintiff must show reliance to recover under 10b-5). "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements ***or actions***." *Central Bank*, 511 U.S. at 180. The Court found that allowing plaintiffs to "circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery as mandated by our earlier cases." *Id.* However, in this case, the alleged scheme and fraudulent course of business ***inflated*** the prices of Enron's ***publicly traded*** securities. Thus, the reliance element is not "***absent***" and the Supreme Court's prior decision in *Basic* is not circumvented – it is satisfied.

Central Bank denied recovery to victims of an alleged securities fraud who pleaded only one theory of recovery against the defendant bank – secondary liability dubbed "aiding and abetting." 511 U.S. at 191. However, the words aiding and abetting do not appear in §10(b) or Rule 10b-5.

The Court said: "***[T]he text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation ... that conclusion resolves the case***" *Id.* at 177. The *Central Bank* plaintiffs did not, as the plaintiffs do here, plead or pursue recovery under the theory that the Outside Directors made false and misleading statements in Registration Statements or annual reports issued to the public ***or*** employed acts and manipulative devices to deceive or engaged in a fraudulent scheme or course of business that operated as a fraud or deceit on purchasers of the securities in issue. In the words of the Court, the plaintiffs "concede that Central Bank did not commit a manipulative or deceptive ***act*** within the meaning of §10(b)." *Id.* at 191. Thus, because the *Central Bank* plaintiffs pursued a theory of recovery which found ***no support in the text of either the statute or the rule, they lost***

Central Bank cannot mean that a defendant cannot be liable under §10(b) unless it made misleading statements because the Court rejected that argument in *O'Hagan*, 521 U.S. 642. The Eighth Circuit had held that, under *Central Bank*, "§10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely." *Id.* at 664 The Court reversed, holding that §10(b) does not require a defendant to speak. *Id.* Because §10(b) prohibits "'any manipulative or deceptive device or contrivance'" in contravention of SEC rules, this reaches "any deceptive device," whether or not the defendant spoke. *O'Hagan*, 521 U.S. at 650-51. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), is consistent with *O'Hagan* In *Superintendent of Ins.*, a ***unanimous*** Court upheld a §10(b)/Rule10b-5 complaint involving a "fraudulent scheme" involving the sale of securities where ***no*** false statement was alleged because:

> ***There certainly was an "act" or "practice" within the meaning of Rule 10b-5 n.5 which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds.***

Id. at 9.

This court has stated, citing *O'Hagan*, that: "***A defendant need not have made a false or misleading statement to be liable.***" *Landry's*, slip op. at 9 n.12; *In re Waste Mgmt., Inc. Sec. Litig.* Civ. No. H-99-2183, slip op. at 75 (S.D. Tex. Aug. 16, 2001);[21] *BMC Software*, 183 F. Supp. 2d at 869.

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[21] Due to the length of these opinions and the fact that this Court has access to them, they have not been attached to this brief.

That this reading of §10(b)/Rule 10b-5 is clearly correct is shown by a new ***unanimous*** Supreme Court decision – *SEC v. Zandford*, __ U.S. __, No. 01-147, 2002 U.S. LEXIS 4023 (June 3, 2002). In *Zandford*, the Court repeatedly cited with approval its seminal "***fraudulent scheme***" case *Superintendent of Ins.*, and reversed dismissal of a §10(b)/Rule 10b-5 complaint making the following key points:

- "***The scope of Rule 10b-5 is coextensive with the coverage of § 10(b)*** ...." *Id.* at *7 n.1.
- "***[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b)***. *Id* at *13.[22]
- Allegations that defendant "***engaged in a fraudulent scheme***" or "'***course of business' that operated as a fraud or deceit***" stated a §10(b) claim. *Id.* at *13, *17.

Thus, *Central Bank* clearly – ***but merely*** – stands for the proposition that no aiding and abetting liability exists under the Exchange Act because neither §10(b) nor Rule 10b-5 contain "aiding and abetting" language. The decision in *Central Bank* is ***quite narrow***. By contrast, the language of §10(b) and Rule 10b-5 is ***very broad*** Also the purposes of §10(b) and Rule 10b-5 are remedial, intended to provide access to federal court to persons victimized in securities transactions:

> [T]he 1934 Act and its companion legislative enactments [including the 1933 Act] embrace a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry ." Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Affiliated Ute Citizens, 406 U.S. at 151. As noted by the Fifth Circuit.

> [T]he Court has concluded that the Exchange Act and the Securities Act should be construed broadly to effectuate the statutory policy affording extensive protection to the investing public. *See Tcherepnin*, 389 U.S. at 336 .. *See also* S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) (indicating legislative intent of the Securities Act to protect the public from the sale of fraudulent ***and speculative schemes***).

Meason v. Bank of Miami, 652 F.2d 542, 549 (5th Cir. 1981). "The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively." *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980).

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[22] To the extent *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001), seems to require a statement be made about a company which is "publicly attributable to the defendant at the time the plaintiff's investment decision was made," it is inconsistent with *Zandford*.

3. The CC Alleges Facts Giving Rise to a Strong Inference of Scienter

a. The Scienter Standard

As amended by the PSLRA, 15 U.S.C. §78u-4(b)(2), the Exchange Act requires that a complaint asserting claims under §10(b) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The Fifth Circuit has joined with the First, Third, Sixth and Eleventh Circuits in ruling that "recklessness" still constitutes scienter for §10(b) and Rule 10b-5 claims *Nathenson*, 267 F 3d at 410-11. *See also Robertson*, 32 F. Supp 2d at 447 ("this Court concludes that allegations of recklessness, as that term is defined for purposes of securities fraud litigation, [are] sufficient to satisfy the requirements of the PSLRA if the allegations raise a strong inference of fraudulent intent").

The Fifth Circuit also recently explained that "[t]he PSLRA neither mandated nor prohibited ***any*** particular method of establishing a strong inference of scienter," *Nathenson*, 267 F.3d at 411, and further ruled that "[t]here does not appear to be any question that under the PSLRA circumstantial evidence can support a strong inference of scienter." *Id.* at 410.

As to the role of "motive and opportunity" as a method of proving scienter, in *Nathenson* the Fifth Circuit clarified its view that the "most sensible approach" was that adopted by the Sixth Circuit in *In re Comshare, Inc. Secs. Litig.*, 183 F.3d 542, 551 (6th Cir. 1999), that "motive and opportunity could be 'relevant' to pleading scienter and 'may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct.'" *Nathenson*, 267 F.3d at 410-11 (quoting *Comshare*, 183 F.3d at 551).

Nathenson thus restates the conclusion of courts in the Fifth Circuit that "[p]laintiffs may meet the heightened pleading requirements of Rule 9(b) and the PSLRA as applied to Section 10(b), by '***alleging either motive and opportunity to commit fraud, or by pleading facts which identify circumstances indicating Defendants' conscious or reckless behavior, so long as*** the totality of the allegations raises a strong inference of fraudulent intent.'" *Robertson*, 32 F. Supp. 2d at 447 (quoting *Zuckerman v. Foxmeyer Health Corp.*, 4 F. Supp. 2d 618, 623 (N.D. Tex. 1998)).

In this case, these facts alleged undoubtedly demonstrate a strong inference of scienter, *i.e.*, that defendants knew the truth about Enron at the time of their statements and omissions or recklessly disregarded the truth.

b. The CC Alleges Facts Indicating Conscious Misbehavior or Recklessness

The Outside Directors' role in the Enron scheme was their approval of the transactions, methods and devices that were the elements of the scheme. The transactions by their size and unusual nature required Board approval. *See* ¶¶395, 398. The facts known to the Outside Directors in several major areas, when taken together with each other and in addition to the insider trading of those directors charged with fraud, support a strong inference of scienter. Below are details compiled from the minutes of certain Enron board minutes that are part of the Congressional Record, indicating the presence and approval of each of the individual Outside Directors charged with fraud at one or more meetings of which significant fraudulent transactions were discussed reported on or approved. A corporate insider who attends a board meeting is considered to possess whatever information is discussed at the meeting. *Adler*, 137 F.3d at 1337.

(1) The Board's Waiver of Fastow's Conflict of Interest Demonstrates a Strong Inference of Scienter

The Outside Directors waived Andrew Fastow's conflict of interest, three times, in 6/99, in 10/99, and in 11/00.[23] The Board did this for the express purpose of boosting Enron's financial performance.

> WHEREAS, the Partnership, as a potential ready purchaser of the Company's businesses and assets or as a potential contract counterparty, could provide liquidity, risk management and other financial benefits to the Company;
>
> WHEREAS, the Office of the Chairman of the Company has determined, for the foregoing reasons, that Mr. Fastow's participation as the managing partner/manager of the Partnership will not adversely affect the interests of the Company.[24]

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23 *See* Chart from Senate Committee, *supra* at 3. *See Epstein v. Itron, Inc.*, 993 F. Supp. 1314, 1325-26 (E.D. Wash. 1998) ("facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the Company and its key officers").

24 Ex. 24.

These actions alone are enough to demonstrate the scienter of those directors who knew of and approved the waiver. First, it was an act so unusual as to be unique in a modern publicly traded large capitalization company. The CC alleges the act was born from desperation to keep debt off balance sheet and keep the earnings already recognized from being removed from income because the transactions were with a related party. ¶26. Given the enormous size of the transactions between Enron and LJM2, the Board's waiver of Fastow's conflict of interest provides a strong inference of the Outside Directors' scienter. *See Epstein*, 993 F. Supp. at 1325-26 ("facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers").[25]

According to testimony from Andersen's criminal trial, an Andersen partner expert in interpreting accounting rules wrote criticizing Enron's plan to allow its Chief Financial Officer to run a partnership that did business with the Company, calling it terrible and asking ***"Why would any director sign off on such a scheme?"***[26]

(2) The Audit Committee's Approval of High Risk, Highly Judgmental Accounting for Earnings Reported in Financial Statements Supports a Strong Inference of Scienter

Andersen warned the Audit Committee members that many of Enron's accounting practices were "high risk." *See, e.g.*, Ex. 16. In 99, Andersen told the Audit Committee that Enron's "highly structured transactions" were "high risk" and that the significance of earnings associated with those transactions heightened the need for disclosure. Similarly, they were told that Enron's commodity and equity portfolios also were "high risk" and the significance of merchant asset earnings heightened the need for disclosure. *Id.* In 00 Andersen told the Audit Committee that Enron depended highly on complex transactions "to meet objectives" and that the application of mark-to-market accounting for new products "continues to present challenges" and create valuation issues. Ex. 27 This provides further evidence of the Outside Directors' scienter. *See Gelfer v. Pegasystems,*

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25 *See* Chart from Senate Committee, *supra* at 3.

26 Kurt Eichenwald, "Andersen Lawyer Accuses Prosecutors of Misconduct," *New York Times*, 5/9/02.

Inc., 96 F. Supp 2d 10, 17 (D. Mass. 2000) (management letters from accountant warning of "'material weaknesses in the Company's internal control environment'" and recommending changes in revenue recognition and financial reporting put defendants on notice of deficiencies in their accounting practices and supported finding of recklessness).

The Audit Committee (Chan, Foy, Gramm and Jaedicke) was given the information about Enron's fraudulent transactions, and they continued to sign Enron's 10-Ks reporting Enron's financial results, which have been restated for reasons that they were warned about. The Outside Directors argue that GAAP violations alone do not suffice to demonstrate scienter, but here the Board was warned of the very risks that came to fruition, and caused Enron's financial downfall.

The Audit Committee members, Chan, Foy, Gramm and Jaedicke, had actual knowledge and were actually informed that the accounting practices, used in the fraudulent transactions the CC describes, were high risk or highly judgmental and thus were subject to scrutiny or reversal. Thus, the Audit Committee members were involved to an exceptionally high degree in approving these accounting practices that were at the center of the fraud. Plaintiffs' allegations of defendants' scienter are more than sufficient.

(3) The Significant Restatements of Enron's Financial Statements Support a Strong Inference of Scienter

The magnitude of Enron's restatements provides a strong inference of scienter. *Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000) (magnitude of $73.8 million write-off taken together with allegations of poor sales sufficiently alleged facts supporting strong inference of recklessness); *Gelfer*, 96 F Supp. 2d at 16 (magnitude of the revenue overstatements during the class period tends to support a strong inference of scienter; restatement corrected an $18 million revenue overstatement and $11 million income overstatement); *In re Ancor Communications, Inc.*, 22 F. Supp. 2d 999, 1005 (D Minn. 1998) (substantial overstatements of revenues supported strong inference of conscious behavior); *In re Employee Solutions Sec. Litig.*, No. 97-547-PHX-RGS-OMP, 1998 U.S. Dist. LEXIS 16444, at *3, *8 (D. Ariz. Sept. 29, 1998) ("the alleged magnitude of defendants' failure to keep adequate reserves arguably shows reckless disregard for material misrepresentations in the financial statements"; company reported $3 1 million income in a quarter, whereas adequate reserves would have resulted in a $0.4 million net loss); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1313-14 (C.D. Cal. 1996) ("A violation of [GAAP] may be used to show that a company overstated its income, which may be used to show the scienter for a violation of Section 10(b) and Rule 10b-5.... The fact[] that the allegedly overstated revenues constituted such a significant portion of [defendant's] total revenues ... tend[s] to support the conclusion that the defendants acted with scienter." Fifty percent of $7 million of reported annual revenues was allegedly from contract with an unexpired right of return.).

Perhaps the Northern District of Illinois summed it up best: "The more serious the error, the less believable are defendants['] protests that they were completely unaware of [the company's] true financial status and the stronger is the inference that defendants must have known about the discrepancy." *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1256 (N.D. Ill. 1997) (massive year-end increase of $5 million in credit loss reserves and slashing of reported yearly earnings from $3.530 million to $325,000 "weigh[ed] heavily in favor of a finding of reckless disregard").

While, as a general proposition, a restatement of earnings does not ***automatically*** support a strong inference of intent to defraud, "the overstatement of significant revenues ... supports the claim that the defendants acted in a severely reckless manner." *Haack*, 2002 U.S. Dist. LEXIS 5652, at *23-*25 (citing *In re MicroStrategy Inc. Secs. Litig.*, 115 F. Supp. 2d 620, 637 (E.D. Va 2000) ("the alleged GAAP violations and the subsequent restatements are of such a great magnitude – amounting to a night-and-day difference with regard to [defendant's] representations of profitability – as to compel an inference that fraud or recklessness was afoot")); *Triton Energy*, 2001 U.S. Dist. LEXIS 5920, at *33-*34 (although GAAP violations ***standing alone*** are insufficient to establish scienter, "this does not mean that 'a misapplication of accounting principles or a restatement of financials can never take on significant inferential weight in the scienter calculus; ***to the contrary***, when the number, size, timing, nature, frequency, and context of the misapplication or restatement are taken into account, the balance of the inferences to be drawn from such allegations may shift significantly in favor of scienter (or, conversely, in favor of a nonculpable state of mind"); *In re McKesson HBOC, Inc. Secs. Litig.*, 126 F. Supp. 2d 1248, 1273 (N.D. Cal. 2000) ("[W]hen significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves."); *SEC v. DCI Telecomms.*, 122 F Supp. 2d 495, 500 (S.D.N.Y. 2000) (alleged GAAP violations, *i.e.*, improperly accounting for seven acquisitions and grossly overvaluing a purported $15 million contract and $5 million promissory note, which caused company's SEC filings allegedly to overstate assets by 40% to 1408%, "if true, do not present a case of 'misguided optimism,' but rather show a pattern of knowingly misleading practices that ***overwhelmingly overstated*** **revenues**, made with an intent to defraud").

Defense contentions that the size of a restatement actually suggests the lack of intentional or reckless conduct "will not [be] entertain[ed] [on a motion to dismiss] because it concerns a factual dispute about motive." *Haack*, 2002 U.S. Dist. LEXIS 5652, at *25 (citing *MicroStrategy*, 115 F. Supp. 2d at 631) (the court, on a motion to dismiss a securities fraud claim "must take the factual allegations in the complaint as true, draw whatever inferences regarding the defendant's state of mind are supported by these allegations, and determine whether these inferences individually or cumulatively provide a strong – or 'persuasive' and 'cogent' – inference that the defendant possessed the requisite state of mind"). Nonetheless, the Outside Directors attempt to downplay and minimize the mammoth Enron write-downs, GAAP violations and restatements here – defying all reason in the process.

(4) The Fraudulent Transactions and Policies Alleged in the CC Required Board Approval

Because Enron's fraud was executed on a strategic level, Enron's Board knew of and approved the very fraudulent transactions, conflicts of interest and deceptive accounting at the core of the scheme. These frauds are not day-to-day minutia that management carried out at a level below Board notice. Where a typical fraud case might involve improper recognition of revenue in violation of a company's policies, the fraud here involves setting up Company-wide mechanisms and policies that were ***designed*** to recognize fraudulent revenue. "Moreover, the circumstances surrounding revenue recognition also support a strong inference of conscious behavior." *Ancor Communs.*, 22 F. Supp. 2d at 1005 (substantially overstating revenues by reporting consignment transactions as sales constitutes making false or misleading statements of material fact). The transactions described were so unusual, so large and of such importance to Enron's financial existence that the Board's approval of them was necessary, and thus plaintiffs' allegations satisfy the existence of a special circumstance that *Nathenson* holds can be a basis for scienter: "[N]ormally an officer's position with a company does not suffice to create an inference of scienter. However there are a number of special circumstances here which, taken together, suffice to support a different result in the present case." 267 F.3d at 424-25. The circumstances in that case were the small size of the company and its dependence on a single patent. Here the special circumstances are even more compelling, because, although Enron was a large company, the transactions were of such large size that the Board's approval was required to enact them. Moreover, the waiver of the duty of undivided loyalty to the Company of the CFO, in order to allow him to manage JEDI and the LJM partnerships so that Enron could recognize a large part of its earnings in transactions with these sham SPEs, is something uniquely within the purview of the Outside Directors and their fellow Board members.

Contrary to defendants' assertions (Outside Dir. Br. at 45), plaintiffs are not merely relying on the individual defendants' board positions to establish scienter. Plaintiffs have alleged facts concerning defendants' involvement with and approval of the fraudulent transactions and the clear difference between what defendants were telling the public and the true state of affairs at Enron. ¶¶121, 155, 214, 300, 339, 395. *See Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir. 2001) ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.").

(5) The Scheme and Deceptive Devices of the Outside Directors Demonstrate a Strong Inference of Scienter

The Outside Directors can claim neither ignorance nor innocence with respect to the Enron debacle. The Outside Directors had an extensive and extremely close relationship with management by which they gained knowledge of the fraudulent scheme and took affirmative steps to further it Lay, Skilling, Causey, McMahon or Fastow, throughout the Class Period, regularly reported to the Board discussing Enron's business, financial condition, financial needs and plans, partnerships, SPEs and future prospects. The Outside Directors received detailed knowledge of Enron's secretly controlled partnerships that management set up to facilitate illicit and contrived SPE transactions which falsified Enron's financial statements and misrepresented its financial condition. ¶¶397-398. At the same time, the Outside Directors named as defendants for claims under the Exchange Act, with possession of this undisclosed information, sold their Enron stock and profited personally *As alleged, this is intentional participation in the fraud*.

Thus, the Outside Directors, because of their knowledge and approval of transaction after transaction and of accounting manipulations across an array of Enron's businesses were primary actors in the fraudulent scheme and course of business in several ways and in so doing engaged in or made repeated contrivances, devices to deceive and misleading statements. The Outside Directors signed and approved offerings of Enron and Enron-related securities, sales often accomplished via false registration statements. The Outside Directors also knew that Enron's banks "pre-funded" LJM2 on 12/22/99 with $3.75 million, and lent $65 million to LJM2 which funded four critical 99 year-end deals to create phony profits for, and hide debt of, Enron. The Outside Directors continued to receive reports and approve LJM2 during 00-01, while it engaged in repeated non-arm's-length deals with Enron to artificially boost its profits by hundreds of millions of dollars, while hiding billions dollars of debt – deceiving the securities markets *Again, as alleged in the CC, this is intentional participation in the fraud*.

In evaluating the adequacy of the scienter allegations against the Outside Directors, it is important to keep in mind the different liability theories being alleged under §10(b) and Rule 10b-5 against these directors. While the CC alleges that the Outside Directors made false and misleading statements in Registration Statements and annual reports, the Outside Directors' liability is ***not limited*** to those allegedly false and misleading statements. The CC also alleges the Outside Directors' liability for ***their*** conduct in participating in the scheme to defraud or course of business that operated as a fraud and deceit on purchasers of Enron publicly traded securities. This distinction is important because ***if*** the CC fails to adequately allege the falsity of the Outside Directors' own statements ***or*** the Outside Directors' knowledge or reckless disregard of the falsity of those statements, the CC may still adequately allege that the Outside Directors knowingly or recklessly employed deceptive acts or participated in the fraudulent scheme or course of business ***or vice versa***.

These are distinct liability theories – one based on ***statements***, the other based on ***conduct*** – which can result in liability, either in combination or separately

It is clear that for §10(b) or Rule 10b-5 liability to attach under either theory, ***scienter must be present,*** *i.e.*, there must be either intentional or reckless conduct. Thus, with respect to the Outside Directors' alleged deceptive acts and participation in the fraudulent scheme or course of business, scienter would be adequately alleged if the facts pleaded give rise to a "strong inference" that in committing those acts, the Outside Directors acted with the "required state of mind," *i.e.*, they acted intentionally or recklessly. This would be so even if the Outside Directors had no knowledge that their ***own statements*** in Registration Statements were false and misleading, for as this Court has recognized, ***it is not necessary that a defendant made a false statement to be liable under §10(b) or Rule 10b-5***. *Landry's*, slip. op at 9 n.12.

During the Class Period, the Outside Directors received regular reports on Enron's actual and contingent liabilities, its liquidity position, any equity issuance obligations it may have which could adversely affect its shareholders' equity, any debt on which Enron may have been potentially liable, even if not on Enron's books directly, the quality of Enron's profits and earnings and Enron's actual ***liquidity***, including sources of funding to support repayment of any loans. In addition, the Board ***was required to closely monitor Enron by frequently reviewing its financial condition and ongoing operations for any material changes and insist that Enron's top financial officers keep it informed of the current status of the borrower's business and financial condition***. In fact, the Finance Committee received a report from then Treasurer McMahon discussing Enron's liquidity and financings on 10/11/99. *See* Ex. 23. At that same meeting, the Board received a report from Chief Risk Officer Buy about Enron's top 25 credit exposures. *See* Ex. 24.

At a 5/1/00 Finance Committee meeting, McMahon reported on Enron's need for additional borrowing, *see* Ex. 26, and at an 10/6/00 meeting CFO Fastow reported that Enron's average weighted cost of capital was 17.17%, and that if a projects' return was below that number Enron would have to provide more funding to the project.

As a result, the Outside Directors had obtained extremely detailed information concerning the actual financial condition of Enron throughout the Class Period and knew that the actual condition of Enron's business, its finances and its financial condition was far worse than was being publicly disclosed by Enron. Thus, the Outside Directors knew (or were reckless in not knowing):

1. Enron had set up LJM2 at year-end 99 so that Enron could use SPEs funded by that vehicle to engage in non-arm's-length self-dealing transactions which would enrich the investors in the LJM2 partnership and, at the same time, permit Enron to generate artificial profits and conceal its true debt level by moving billions of dollars of debt off its balance sheet and onto the balance sheet of LJM2's SPEs;

2. Enron was also engaging in similar non-arm's-length transactions with another limited partnership, JEDI, and an associated SPE known as Chewco, which was also permitting Enron to artificially inflate its reported earnings while moving large amounts of debt off its balance sheet,

3. Enron's actual financial condition and results from operations were far worse than what was being publicly disclosed or presented: (i) because Enron was falsifying its financial results and misusing and abusing mark-to-market accounting, resulting in Enron's profitability being far less than publicly reported; (ii) because Enron was improperly moving debt off its balance sheet and onto the balance sheets of entities it secretly controlled, Enron's true debt level and leverage was much higher than what was being publicly presented; and (iii) because of the foregoing, Enron's liquidity and creditworthiness were far worse than publicly known and its financial condition much more leveraged and precarious than was being disclosed to public investors;

4. Enron had entered into a number of transactions with secretly controlled SPEs being funded by LJM2, which bank executives were secretly funding while administering LJM2's affairs, to finance transactions that would require Enron to issue millions of shares of Enron common stock if Enron's common stock fell below trigger prices ranging from $83-$19 per share. Not only could Enron be required to issue huge amounts of additional stock, also, the debt of the SPEs with which Enron was doing business would not, in fact, be non-recourse to Enron as represented but, in fact, would become and be recourse to Enron if, as and when Enron's credit rating was lowered – something the Outside Directors knew would occur if, as and when Enron's true financial condition became public or became known to the rating agencies.

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Thus, Enron's Board had continuous contact with Enron's top executives and Enron's financial records, finances, plans, etc., ***in connection with a series of large ongoing major transactions, as well as every Enron securities offering between 98 and 01***! Thus, this is ***not*** a situation of alleging scienter against Outside Directors who had only minimal contact with the transactions alleged to be fraudulent. Here, the fraud was at the strategic and policy level such that it took place within the boardroom as well as the executive suites.

c. Plaintiffs' Insider Trading Allegations Constitute Additional Circumstantial Evidence of a Strong Inference of Scienter

(1) The Outside Directors' Monumental Stock Sales Demonstrate a Strong Inference of Scienter

The fact that the Outside Directors named as defendants under Exchange Act claims also sold off substantial amounts of their personally held Enron common stock at suspicious times during the Class Period, although not required, further supports a finding of scienter. *See, e.g.*, *Nathenson*, 267 F.3d at 412 ("What must be alleged is not motive and opportunity as such but particularized facts giving rise to a strong inference of scienter. Appropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter ..."). Such sales are certainly enough to further support a strong inference of scienter in this case. *See, e.g.*, *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 85-86 (2d Cir. 1999) (large sales by several officers, including one officer who sold 40%, sufficient to establish motive); *Friedberg v. Discreet Logic*, 959 F. Supp 42, 50-51 (D. Mass. 1997) (although defendants sold a "small percent" of their total combined holdings, stock sales supported a finding of scienter because of net amount raised and the fact that two individuals sold 50% and 33% of their individual holdings); *In re Oxford Health Plans, Inc. Sec. Litig.*, 187 F.R.D. 133, 140 (S.D.N.Y. 1999) (profits from insider sales were "massive by any measure" given the tens of millions of dollars received by each individual defendant).

Plaintiffs have sufficiently alleged scienter by setting forth the Outside Directors' motive to artificially inflate the value of Enron stock in order to personally profit from illegal insider sales. ¶83. Stock transactions can provide a strong inference of scienter where they are "unusual." *Nathenson,* 267 F.3d at 421. The CC demonstrates that Outside Directors' sales during the Class

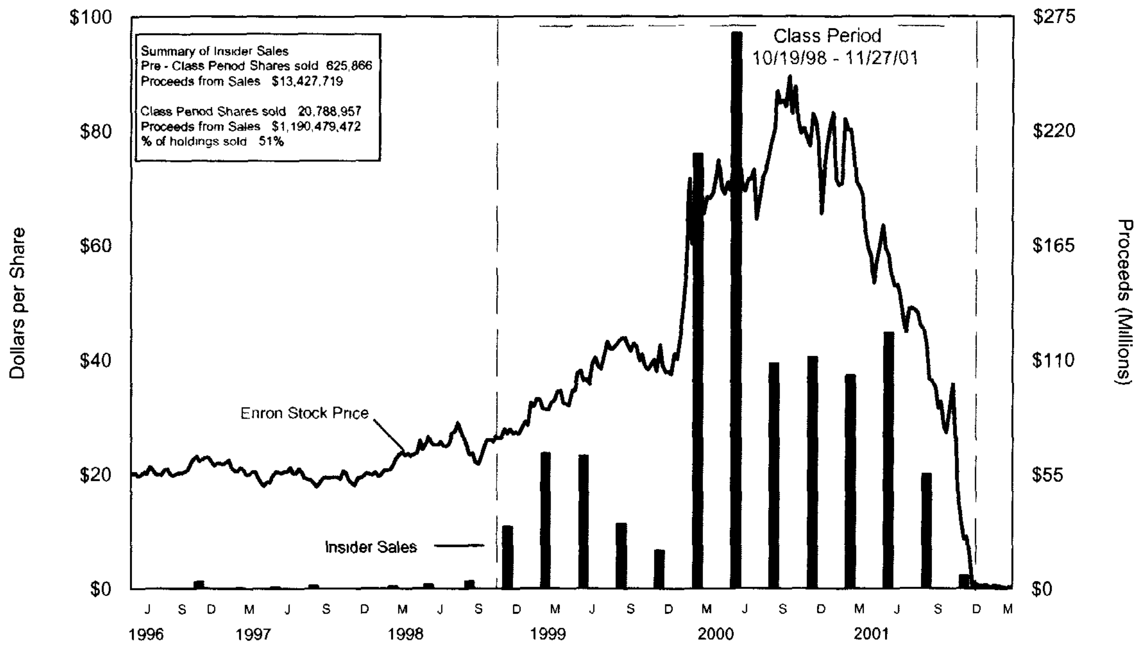
Period were unusual in timing and amount. ¶¶84, 403-417. In the Fifth Circuit, at the pleading stage, "[i]nsider trading in suspicious amounts or at suspicious times is, of course, presumptively probative of bad faith and scienter." *Rubinstein,* 20 F.3d at 169; *see also Comshare,* 183 F.3d at 553 ("the charge that corporate officers engaged in insider sales at unusual or suspicious levels 'is probative of motive'") (citing *Stevelman*, 174 F. 3d at 85).

Collectively, the Enron Defendants sold over 20 million shares of Enron stock during the Class Period for ***over $1.1 billion*** in illegal insider trading proceeds. ¶¶84, 403. The suspicious nature of the Enron Defendants' timing and unusually large amount of trades is elegantly depicted by the stock sales chart in ¶¶84 and 403 of the CC, reproduced below for the Court's convenience:

Enron Corp.

Insiders' Quarterly Shares Sold (Dollar Volume)

June 1996 - November 2001



This chart strongly suggests that the Outside Directors (as well as all Enron Defendants), knew that Enron stock was inflated by the accounting improprieties for which Enron and its accountants are now under Congressional and criminal investigation. Indeed, it is difficult to imagine how Class Period sales of $1.19 billion worth of stock compared to pre-Class Period sales of a mere $13 million (an almost 100 fold difference) would not meet the "suspicious amounts" at "suspicious times" standard.[27]

This Court has found that insider sales amounting to far less than the Enron Defendants' percentage was probative of scienter in *Landry's*, slip op. at 26, 62-63. In *Landry's*, this Court acknowledged the amount of trading by *Landry's* insiders as illustrated on the chart listed below. Comparing the defendants' sales in *Landry's* to the Enron Defendants' sales clearly demonstrates that these sales were unusual and suspicious:

In addition, plaintiffs included with their CC an expert study scientifically demonstrating that the above selling could not have occurred by mere chance. *See* Declaration of Scott Hakala dated 4/5/02 ("Hakala Decl."), ¶27 attached as Ex. B to Lead Plaintiffs' Appendix of Exhibits in Support of Consolidated Complaint ("CC App.") filed 4/8/02. Using sophisticated and well-accepted

[27] Charts breaking down these sales for each individual Enron Defendant are listed in ¶83 of the CC.

methods of event studies, Dr. Hakala's study confirms that the chance that the insider trading could have occurred for some other reason than based upon material insider information is less than one chance in one thousand. Given that plaintiffs' burden at trial is to prove facts at the "more probable than not" standard, Dr. Hakala's study is clearly adequate to plead scienter.

Dr Hakala took the additional step of analyzing the Enron Defendants' option exercises utilizing the latest techniques of option valuation coupled with empirical research on executive option exercise behavior. By combining these techniques, Dr. Hakala was able to compare the Enron executives' behavior not only with what modern economics would expect, but also with how honest executives actually behave, and, indeed, with how these same Enron executives acted prior to the Class Period. Dr. Hakala's finding of some 120 option exercises during the Class Period which no honest executive would ever have undertaken absent foreknowledge that Enron's stock was about to plummet also establishes scienter. *See* Hakala Decl., ¶25.

The Outside Directors either fail to cite any judicial support or merely rely on non-binding decisions from within the Ninth Circuit to argue that their sales of Enron stock cannot be the basis of a strong inference of scienter. The Outside Directors all but ignore this Court's pertinent decision in *Landry's*, which clearly demonstrates that the Outside Directors' trades were unusual and suspicious. *See Landry's*, slip op. at 25 (insider selling by defendants netting over $39 2 million in illegal insider-trading proceeds was unusual in timing and amount).

Further, as demonstrated below, plaintiffs made numerous specific allegations that the Outside Directors sold large amounts of Enron stock, constituting large portions of their holdings, in close temporal proximity to false positive statements. ¶¶188, 222, 235, 261, 299. *See In re Secure Computing Corp.*, 184 F. Supp. 2d 980, 990 (N.D. Cal. 2001) (finding circumstantial support for the inference of deliberate recklessness in the temporal proximity between defendants' last positive statements regarding the company's financial status and the disclosure of negative information); *see Stevelman*, 174 F.3d at 85-86 (sale of officers' stock in proximity to allegedly false optimistic statements was significant to issue of whether sales were unusual and suspicious).

Moreover, allegations as to the suspicious amount and timing of the Outside Directors' trading cannot be disregarded ***as a matter of law***. Whether the Outside Directors' sales were unusual is an issue of fact that is inappropriate for resolution at the pleading stage. *See Rubinstein*, 20 F.3d at 170 n.38 (defendants explanations as to why stock sold inappropriate at motion to dismiss because it is "impossible" for the court to consider defendants' evidence at pleading stage). On a motion to dismiss, the Court must accept all allegations of the complaint as true. "The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support its claims." *BMC Software,* 183 F. Supp. 2d at 866. Nevertheless, assuming, *arguendo,* that defendants' arguments about their insider sales could be considered at the pleading stage, their arguments fail.

(2) The Length of the Class Period Does Not Preclude the Strong Inference of Scienter Evidenced by the Outside Directors' Massive Class Period Trading

Contrary to the Outside Directors' assertion, the strong inference of scienter evidenced by the Outside Directors' insider trading during the Class Period is not precluded by the length of the Class Period. Outside Dir. Br. at 19-20. *In re Vantive Corp. Secs. Litig.,* 283 F.3d 1079 (9th Cir. 2002), relied on by the Outside Directors, merely held that the length of the class period weighed against a finding of scienter because ***in that particular case*** the plaintiffs failed to support an inference of fraud throughout the entire class period, and adopted a long class period for the sole purpose of "sweep[ing] as many stock sales into their totals as possible." *Id.* at 1092.

Unlike in *Vantive,* plaintiffs do not extend the Class Period for the sole purpose of increasing the amount of defendants' stock sales. (Rather, the length of the Class Period is co-extensive with the financial fraud as admitted by defendants when Enron restated its financials.) In fact, most of the Outside Directors' stock sales occurred late in the Class Period, between 3/00 and 9/01. ¶83(v), (w), (x), (y), (aa) and (bb). Plaintiffs have clearly pled that the Outside Directors' Class Period sales dramatically exceeded their sales prior to the Class Period. ¶403. Plaintiffs have alleged that the Enron Defendants sold between 20%-100% of their Enron holdings during the Class Period, netting over $1 billion in illegal insider sales. Such sales clearly evidence a strong inference of scienter ¶402. *See Landry's*, slip op. at 25 (defendants' individual sales of between 30%-87% of their holdings netting over $39.2 million suspicious); *In re Miller Indus.*, 12 F. Supp. 2d 1323, 1332 (N.D. Ga. 1998) (individual defendants sold more than 2,188,700 shares, valued at $53 million); *see also*

Powers v. Eichen, 977 F. Supp. 1031, 1039 (S.D. Cal. 1997) (sales of three individual defendants' stock holdings – 100%, 40% and 30% of their respective holdings – "serves as circumstantial evidence that the Defendants knew that [the company's] stock prices would soon drop because the company was experiencing serious difficulties getting its DP products to the market"). Thus, viewed in the totality of the circumstances in this case, the length of the Class Period does not weigh against finding the Outside Director's sales probative of scienter.

Furthermore, Dr. Hakala's declaration showed that the long Class Period here did not confound his insider trading analysis. Hakala Decl., ¶11. Dr. Hakala describes peer reviewed academic research that suggests increased insider sales over extended periods of time prior to a negative disclosure can, and often do, signal or imply insider knowledge that the share price was inflated. Hakala Decl., ¶11. Dr. Hakala provides additional studies to show that insiders often begin selling shares at an increased rate well in advance of negative earnings disclosures, tend to increase their rate of sales of shares in the year prior to the negative event, and may tend to increase sales over time as the negative earnings event becomes more certain and proximate. *Id.* Other studies cited by Dr. Hakala suggest that insiders have a general understanding that their respective companies are over-valued for some period of time prior to a negative disclosure event or prior to a relative decline in their company's stock price. *Id.* Thus, to avoid liquidity problems insiders often begin liquidating their holdings well before the negative earnings trend or under-performance is disclosed to or realized by the market. *Id.* Indeed, Outside Directors' sales during the period of their fraudulent activity follow the very patterns described in the research and studies Dr. Hakala points to.

(3) Plaintiffs Did Not Fail to Consider Pre-Class Period Sales

One method of demonstrating that insider trading is unusual is to plead that insider trading is out of line with prior trading practices. *See Landry's*, slip op. at 50 ("'trading must be in a context where defendants have incentives to withhold material, nonpublic information, and it must be unusual, well beyond the normal'") (quoting *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999). As clearly demonstrated above, plaintiffs have met this standard. Indeed, as described in the CC, the Enron Defendants' proceeds from trades during the Class Period were approximately

100 times those in prior periods. ¶403. Thus, plaintiffs have established that the Enron Defendants' trades were out of line with prior trading practices. *See Landry's*, slip op. at 25 (class period sales were suspicious because defendants sold 1,448,000 shares during the class period and no sales prior to the class period); *see also Secure Computing*, 184 F. Supp. 2d 980 (class period sales were suspicious because defendants had no stock sales prior to the class period and sold 200,000 shares of stock during the class period).

Plaintiffs alleged pre-Class Period sales by three Outside Directors – Belfer, Foy and Gramm and seven Enron Insiders – Lay, Skilling, Fastow, Horton, Harrison, Mark-Jusbasche and Sutton, ¶¶83(a), (b), (c), (g), (l), (n), (r), (v), (z) and (cc), and demonstrated that all ten of these Enron Defendants' pre-Class Period sales were dwarfed by their Class Period sales, evidencing that the Class Period sales were highly unusual and suspicious in timing and amount. *Id.*

Moreover, although the Outside Directors argue that the Court should disregard plaintiffs' allegation that the vast majority of the Outside Directors did ***not*** sell Enron stock before the Class Period (Outside Dir. Br. at 28), the Outside Directors fail to contradict the CC with evidence that any Outside Directors, other than those already identified in the CC, made sales prior to the Class Period. The CC clearly sets forth the amount of trades made by each Outside Director (who sold during the Class Period) both pre-Class Period and during the Class Period. ¶83(v)-(cc). A comparison between pre-Class Period sales and Class Period sales clearly illustrates a substantial increase in insider trading during the Class Period. *Id. See Marksman Partners*, 927 F. Supp. 1297 (insider sales highly unusual where defendant had not sold any of her stock in the three years prior to the Class Period).

(4) Defendants' Failure to Sell All of Their Shares or to Maximize the Timing of Their Stock Sales Does Not Undercut the Strong Inference of Scienter

Similarly, plaintiffs have adequately demonstrated that the mere fact that some Outside Directors did not sell their shares at the highest price, purchased shares during the Class Period[28] and that fact that they retained portions of their shares when Enron filed for bankruptcy does not undercut the strong inference of scienter. Outside Dir. Br. at 17-23. As previously noted, the Eighth Circuit has recently addressed and rejected these claims in holding that a CEO's failure to sell all of his stock did not undercut a finding of scienter. *See Florida State Bd.,* 270 F.3d at 662; *see also San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos.,* 75 F.3d 801 (2d Cir. 1996) (defendant's retention of a large portion of company stock did not vitiate insider trading liability).[29]

That the Outside Directors were unable to completely divest themselves of all Enron shares prior to Enron's demise does vitiate their intent to profit from illegal insider trading. As phrased by the Eight Circuit, "[t]he ultimate profitability of a course of conduct is not conclusive of intent. Just as we cannot countenance pleading fraud by hindsight, neither can we infer innocence by hindsight because the alleged misdeeds did not pay off." *Florida State Bd.*, 270 F.3d at 662.

(5) The Outside Directors' Trading Was Suspicious Both Individually and in Aggregate

(a) Joe Foy

Foy claims his retirement precludes a finding of scienter based on his sales. But this ignores the facts that make his sales suspicious. *Greebel*, 194 F.3d at 206, which Foy cites, does not hold that retirement gives you a free ticket to commit securities fraud. The executive in *Greebel* "sold

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28 It should be noted that five of the eight Outside Directors alleged to have increased their Enron holdings during the Class Period have not been sued for fraud. Thus, the fact that Outside Directors not accused of engaging in insider trading purchased Enron stock during the Class Period is irrelevant.

29 *See also In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 931 (9th Cir. 1993) ("While 'allegations of unusual insider trading by defendants immediately preceding the disclosure of negative news' may be ... characteristic of a 'typical securities fraud class action,' they are not required."); *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 507 (9th Cir. 1992) (scienter established despite the fact that the "officers did not sell their stock during the class period"). Thus, the fact that some of the defendants may not have sold all of their stock does nothing to negate the inference of scienter.

a considerable number of shares ***after*** he left the company." *Id* at 206. Foy's largest sales were a year ***before*** his departure. Other facts tip the balance in favor of suspicion. For example, Foy's largest sales on 2/25/99 of 15,360 shares for proceeds of $515,482 came just 18 days after he received undisclosed information at an Audit Committee meeting that Enron's accounting for structured transactions and its use of mark-to-market accounting were highly risky.[30] Foy failed to disclose this fact when he sold. His next sales, of 13,680 shares for total proceeds of $472,029 came on 3/18/99, two weeks after Enron's 98 10-K which Foy signed, and which contained admittedly false financial information – was released.

His other sales of 9,120 shares for proceeds of $652,080 came on 1/21/00, less than three months after he and other Board members waived the conflict of interest of Fastow so that Fastow could engage in transactions between LJM2 and Enron in order to boost Enron's earnings and hide its debt. Foy, as an Audit Committee member, had detailed information about the reality of these transactions and how they falsely inflated Enron's earnings and stock price. The 1/21/00 sales were at a price of $71.50 per share, near the stock's peak.

Just because Foy, like Skilling, knew enough to get out of the game early, does not mean he did not know exactly what the game was.

(b) Dr. Wendy Gramm

Although the CC alleges one stock sale by Gramm in 11/98, since Gramm was on the Audit Committee she knew, at the very least, of the information about the formation of and accounting for Chewco which was formed in 11/97. Thus, she sold while in possession of undisclosed information.

(c) Robert Jaedicke

Jaedicke, like Gramm and Foy, was an Audit Committee member who had access to and control over the most damaging inside information about how Enron was accounting for its earnings. On 2/24/00, Jaedicke sold 5,630 shares for proceeds of $353,438, three months after approving the waiver of Fastow's conflict of interest and the setup of LJM2 in 10/99. Jaedicke's sale on 5/2/01 of 8,000 shares for proceeds of $488,000, was three months after a 2/01 Audit Committee meeting at

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30 Detail of the Enron insider stock sales is contained in Ex. C to the CC App

which Jaedicke learned that Enron "continued to utilize highly structured transactions, such as securitizations and syndications, in which there was significant judgment required in the application of GAAP."[31]

(d) Charles Le Maistre

LeMaistre sold 7,360 shares for proceeds of $313,683 on 12/28/99. This sale was timed about two months after he and other directors approved the wavier of Fastow's conflict of interest, and set up LJM2, which allowed Enron to fraudulently boost its earnings substantially for 99. LeMaistre also sold 8,000 shares for $469,120 on 5/10/01, three months after a 2/01 Audit Committee meeting at which Enron's high risk accounting was discussed.

(e) Ronnie Chan

Chan sold 8,000 shares on 7/26/99 for proceeds of $337,200. This sale came after he learned, at the 2/7/99 Audit Committee meeting, that Enron's highly structured transactions and use of mark-to-market accounting were at high risk for accounting judgments, disclosure judgments and rule changes, and four months after he signed the Company's 98 10-K.

(f) John Duncan

Duncan sold 35,000 shares for $2,009,700 in early 5/01 at a time when he knew Enron's true financial condition was extremely fragile and close to piercing additional stock issuance triggers. ¶83(y). Duncan sold his shares after the Enron defendants and Enron's accountants, lawyers and bankers restructured several of the SPEs with which Enron had done illicit transactions in order to artificially boost its profits and hide debt in an effort to support Enron's declining stock price – which had fallen to as low as $51-33/64. ¶313. As Enron and its bankers flooded the market with very positive statements about Enron's finances and business and after Enron reported better-than-expected 1stQ 01 results, Enron's stock stabilized and increased in price to as high as $64-3/4 at the end of 4/01, the very time Duncan made his single $2 million sale, and immediately prior to Enron's stock price falling below the Raptors' pre-determined price triggers which ultimately caused Enron's demise. ¶¶74, 324.

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[31] Ex. 28

(g) Norman Blake

Although Blake only sold on one day, 10/31/00, he received proceeds of $1,705,328 for the sale of 21,200 shares. This single large sale is suspiciously timed three weeks after Blake attended a meeting of the Finance Committee in which he learned that Enron's weighted cost of capital was 17.17%, that there was a "significant increase" in Enron's guarantee portfolio (due to guarantees of SPE obligations and the stock hitting triggers), and that EES was "lagging behind projections," had substantial capital expenditures and that EES's earnings would be negatively affected. *See* Ex. 27.

(h) Robert Belfer

Belfer portrays himself as "the biggest individual victim" of the Enron collapse. Hardly. Belfer reaped stock sales proceeds of $111 million dollars. ¶83(v) An insider who walks away with $111 million dollars is hardly a "victim," because he ***might*** have made ***even more*** from his fraud. Moreover, Belfer also conveniently omits to inform the Court that most of his holdings were in the form of convertible preferred shares that entitled him to enormous dividends. Enron's 7/1/97 8-B filing where Enron's Cumulative Second Preferred Convertible Stock was registered explained that:

> The annual rate of dividends payable on shares of the New Enron Convertible Preferred Stock is the greater of $10.50 per share or the dividend amount payable on the number of shares of New Enron Common Stock into which one share of New Enron Convertible Preferred Stock are convertible (currently 13.652 shares, subject to adjustment). Such dividends are payable quarterly on the first days of January, April, July and October. These dividend rights are superior to the dividend rights of the New Enron Common Stock and rank equally with the dividend rights on the New Enron 9.142% Preferred Stock.

Form 8-B, at 4.

Belfer held a total of 214,580 convertible preferred shares as of 2/15/01, according to Enron's 00 Proxy. That would indicate an annual dividend of $2,253,090. Belfer was the only defendant who held such shares and these massive dividend payments account for part of his hesitancy to part with all his shares.

Furthermore, Belfer's preferred stock gave him protection from massive risks and financial difficulties facing Enron. Belfer's preferred stock had the following dissolution rights:

> The amount payable on shares of the New Enron Convertible Preferred Stock in the event of any involuntary or voluntary liquidation, dissolution or winding up of the affairs of New Enron is $100 per share, together with accrued dividends to the date of distribution or payment. The liquidation rights of the New Enron Convertible

> Preferred Stock are superior to the New Enron Common Stock and rank equally with the liquidation rights of the New Enron 9.142% Preferred Stock.

Form 8-B, at 4.

Hence, in Enron's bankruptcy, Belfer is first in line among Enron's stock holders – contractually entitled to the assets of the Company ahead of plaintiffs in this case for the amount of $100 per preferred share, or a total claim of $21,458,000. To add insult to injury, Belfer will be entitled to unpaid dividends accrued – some additional $2,253,090 per year.

D. Plaintiffs Have Adequately Alleged a §20A Claim

Defendants argue that plaintiffs' §20A claim fails because, in their view, plaintiffs have failed to allege a predicate violation of the Exchange Act. But as demonstrated throughout this memorandum, plaintiffs have adequately alleged the Outside Directors named under §§10(b) and 20(a) are liable under those same sections as well as under Rule 10b-5. Dismissal of plaintiffs' §20A claim is simply unwarranted as plaintiffs have adequately pled predicate violations of the Exchange Act and have clearly demonstrated that plaintiffs traded contemporaneously with the Outside Directors.

The Outside Directors engaged in enormous insider trading while in possession of material, nonpublic information, selling millions of Enron shares – large percentages of their holdings – at artificially inflated prices.[32] ¶¶83-84, 395-404. For sales between 10/27/98 and 9/21/01, plaintiffs identify the date of each sale, the number of shares sold, and the plaintiff who made a contemporaneous trade. As Exhibit A to the CC App. shows, plaintiffs' trades occurred either on the very same day as the Outside Directors' insider sales or within twenty-four hours of an insider sale.

1. Plaintiffs Traded Contemporaneously with Defendants

Congress adopted the "contemporaneous" standard to enable plaintiffs such as Enron's shareholders to recover against corporate insiders who trade on material, nonpublic information In *MicroStrategy*, which this Court cited with approval in *BMC Software*, the court held:

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[32] *See* Ex. C to CC App.

> This inquiry into contemporaneity proceeds from a recognition that "since identifying the party in actual privity with the insider is virtually impossible in transactions occurring on an anonymous public market, the contemporaneous standard was developed as a more feasible avenue by which to sue insiders."

MicroStrategy, 115 F. Supp. 2d at 662. Congress intended the definition of "contemporaneous" to reflect existing case law:

> The bill does not define the term "contemporaneous," which has developed through case law. *See, e.g.*, *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (2d Cir. 1981); *Shapiro v. Merrill, Lynch, Pierce, Fenner and Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800 (S.D.N Y. 1983).

H.R. Rep. 100-910, at 27 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043. Thus, the contemporaneous requirement is flexible and, so long as plaintiffs' trades occur within a reasonable period of an insider's transaction, plaintiffs satisfy the requirement. *Newbronner v. Milken*, 6 F.3d 666, 669-70 (9th Cir. 1993).

Defendants cavalierly claim only same-day trades can be contemporaneous. Outside Dir. Br. at 52 While it is true that several cases have settled on a same-day window, an equal number have found the requirement satisfied by a longer period of time. *See, e.g.*, *In re Cypress Semiconductor Sec. Litig.*, 836 F. Supp. 711, 714 (N.D. Cal. 1993) (purchase within five days fulfills requirement); *Oxford Health Plans*, 187 F.R.D. at 138 (reasonable period); *In re Eng'g Animation Sec. Litig.*, 110 F Supp 2d 1183 (S.D. Iowa 2000) (three days), *Froid v. Berner*, 649 F. Supp. 1418, 1421 n.2 (D.N.J. 1986) (holding nine days between trades "is unquestionably contemporaneous"); *Gerstein v. Micron Tech.*, No. 89-1262, 1993 U.S. Dist. LEXIS 21214, at *20 (D. Idaho Jan. 4, 1993) (a "few days"); *In re Nord Resources Corp. Secs. Litig.*, No. C-3-90-380, 1992 U.S. Dist. LEXIS 22739, at *21 (S.D. Ohio Dec. 15, 1992) ("liability extends forward a few days from the date of an insider trade"); *In re Silicon Graphics Sec. Litig.*, 970 F. Supp. 746, 761 (N.D. Cal. 1997) (adopting 6-day period). Here, plaintiffs' trades satisfy ***any standard*** of contemporaneity because they occur on the same day or within one trading day of the Outside Directors' stock sales.[33]

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[33] At least one court has held the standard can encompass defendants' entire scheme. In *In re American Bus. Computers Corp. Sec. Litig.*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,839, at 93,055 (S.D.N.Y. 1994), defendants insider traded over a period of several weeks and a pattern and conspiracy of insider trading had been established. The court held, "a class action may be maintained on behalf of all persons who purchased stock on an exchange during the period that

2. Defendants' Arguments Regarding §20A Are Meritless

The Outside Directors make three additional arguments in a vain attempt to extricate themselves from liability. None of these arguments have any merit – all must be disregarded.

First, the Outside Directors argue that claims must be dismissed "with respect to any accused sales" where there is not an exact match between the date of a given defendant's sales and plaintiffs' purchases. The Outside Directors then proceed to list certain trades they claim cannot be considered because those trades were not conducted on the same day. Outside Dir. Br. at 53. But under whatever definition of "contemporaneous" the Court adopts, there is certainly no support for defendants' absurd proposition that a single non-contemporaneous trade can destroy plaintiffs' §20A claim as to trades which were undisputedly contemporaneous with defendants' insider sales. Defendants' quarrel over the contemporaneousness of a few trades, at most, raises a factual question which cannot be resolved at this stage of the proceedings.[34]

Second, the Outside Directors claim certain transactions by defendant Belfer should not be considered because the transactions are not "market sales." Notwithstanding the fact that the statute contains no "market sale" requirement, this argument is belied by the very nature of a costless collar. As the Outside Directors admit, a costless collar consists of "contractual puts and calls" that limit risk. Outside Dir. Br. at 54. And puts and calls are specifically covered in the definition of a security in the Exchange Act. "The term 'security' means ... any put, call, straddle, option, or privilege on any security...." 15 U.S.C. §78(c)(10). *See Moskowitz v. Lopp*, 128 F.R.D. 624, 634-36 (E.D. Pa. 1989) (plaintiff has standing as contemporaneous trader against defendant who purchased

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defendants were selling that stock on the basis of insider information." *Id.* Thus, under this rubric, defendants Gramm and Chan are liable for their trades occurring at any point during the Class Period, despite the fact that their trades are not listed in Ex. A to the CC App. Moreover, the Outside Directors conveniently forget that plaintiffs also plead viable claims against defendants Gramm and Chan under §10(b) and Rule 10b-5 for their role in the Enron fraud as well as their insider trading Thus, even if the Court dismisses plaintiffs' §20A claim against these two defendants, other strong claims are still extant.

34 *In re Worlds of Wonder Sec. Litig.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,004, at 95,631 (N.D. Cal. 1990) ("Given the unclear status of the law on this issue and the undeveloped factual record in this action, it would be premature for the court to determine conclusively the parameters of the 'contemporaneous trading' window."); *Feldman v. Motorola, Inc.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,806, at 97,981-82 (N.D. Ill. 1993).

puts and calls); *see also Dau v. Cephalon, Inc.*, No. 99-CV-2439, 2000 U.S. Dist. LEXIS 14534, at *15-*16 (E.D. Pa. Sept. 25, 2000) (holding contemporaneous purchaser of stock has standing to bring §20A claim against defendant purchasing call options). The Outside Directors cite this Court's decision in *BMC Software* as holding that §20A claims are limited to plaintiffs who traded "on the same market" with the seller. Outside Dir. Br. at 54 (citing *BMC Software*, 183 F. Supp. 2d at 916 n.53). At this point in the proceeding there is no indication that Belfer's puts and calls that made up the costless collars were not on the same market as plaintiffs' purchases. Further, even if the Court accepts the Outside Directors' dubious argument regarding the collars, and ignores Belfer's transfers of shares into an "Investment Partnership" and an "Exchange Fund," Belfer is still liable for the 23 other contemporaneous trades pled in the CC. *See* Exs. A and C to CC App.

Finally, the Outside Directors argue that standing under §20A is limited to "those who also purchased at the same price at which the insider sold." Outside Dir. Br. at 55. The Outside Directors cite *In re AST Research Sec. Litig.*, 887 F. Supp. 231, 233 (C.D. Cal. 1995), for support. But nowhere in the opinion does the court even allude to the Outside Directors' novel "same price" theory. Instead, the *AST* court simply adopted a narrow view of the contemporaneous trading requirement. *See id.* The Outside Directors can point to no case, and plaintiffs know of none, where the contemporaneous trading requirement embraced a "same price" standard. With the rapid pace of trading in a fully developed, volatile market it would be a rare situation indeed where defendants' insider trades were executed at the same price as the injured plaintiffs. The Court should ignore the Outside Directors' creative spin on the law.

In sum, plaintiffs have properly pled all elements of a §20A claim. Congress enacted §20A specifically to provide a remedy to those like plaintiffs listed in Ex. A to the CC App. who traded contemporaneously with insiders who sought profit by trading on material nonpublic information.

E. The Outside Directors Are Liable under §11 of the Securities Act

The Outside Directors are responsible for the contents and dissemination of the Registration Statements. They signed the Registration Statements and participated in the preparation and dissemination of the Registration Statements and Prospectuses by preparing, reviewing and/or signing of the Registration Statements and Prospectuses and thereby causing their filing with the

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SEC. ¶¶1006-1007, 1009. Each of the Outside Directors signed at least one of the Registration Statements that plaintiffs allege was false and misleading. Thus, plaintiffs have alleged a §11 violation by each of the Outside Directors.

The Outside Directors claim that Rule 9(b) applies to §11 of the Securities Act when plaintiffs' allegations "sound in fraud." Moreover, they: (1) hide behind "experts"; (2) claim plaintiffs do not have standing to sue because they cannot trace their purchases to the issuance of the Registration Statement; (3) claim plaintiffs do not adequately allege any material misstatements or omissions; (4) claim plaintiffs did not allege negligence; and (5) claim plaintiffs were required to plead reliance. These all fail.

1. Fifth Circuit Law Makes Clear that Rule 9(b) Does Not Apply to Plaintiffs' §11 Claims

Lone Star Ladies Inv. Club v. Schlotzsky's, Inc., 238 F.3d 363 (5th Cir. 2001), now "makes clear that where a complaint does not allege that the defendants are liable for fraudulent or intentional conduct, where it expressly disavows and disclaims any allegations of fraud in its strict liability 1933 Securities Act claims, its claims do not 'sound in fraud' and the claims cannot be dismissed for failure to satisfy Rule 9(b)." *Accord Landry's*, slip op. at 60 (citing *Lone Star*, 238 F.3d at 368-69). *See Collmer v. U.S. Liquids, Inc.*, No. H-99-2785, 2001 U.S. Dist. LEXIS 23518, at *108 (S.D. Tex. Jan. 23, 2001) ("given the express disavowal of those elements in the complaint that relate to the fraud claims in the Securities Act claims, the Court finds that Plaintiffs have stated claims under the 1933 Act"). As the Fifth Circuit explained:

> ***The lower threshold of liability under section 11 and 12 of the 1933 Act as compared to the 1934 Act here matters a great deal.*** This threshold and its relevance to a Rule 12(b)(6) motion is illustrated by two hornbook principals of securities law. The liability of an issuer to a plaintiff who purchases a security issued pursuant to a registration statement for a material misstatement or omission is "virtually absolute." "Defendants other than the issuer can avoid liability by demonstrating due diligence." And this is an affirmative defense that must be pleaded and proved.

Lone Star, 238 F.3d at 36.

Defendants argue plaintiffs' § 11 claims "sound" in fraud and must satisfy Rule 9(b) and the PSLRA. *See* Outside Dir. Br. at 68-71. Defendants' arguments are contrary to current Fifth Circuit precedent and the prior holdings of the Court. *Lone Star*, *Landry's* and *U.S. Liquids* each unequivocally hold Rule 9(b) does ***not*** apply to plaintiffs' §11 claims where, like here, plaintiff disavowed all allegations of fraud.[35]

Here, plaintiffs have pled their §11 claims in accord with *Lone Star* and *Landry's*, where the Court stated:

> The Court also finds that Plaintiffs have also adequately pled their claims against the Landry Defendants under §11 of the Securities Act. They have identified specific purportedly untrue statements in Landry's Prospectus and alleged that Defendants, who were directors of the issuer and some of whom signed the document, negligently breached their duty to make a reasonable investigation or possess reasonable grounds for believing that the representations were true and not materially misleading. The complaint expressly disavows reliance on or incorporation of the allegations elsewhere in the complaint alleging fraud, thus falling within the holding of *Melder*, 27 F.3d at 1100 n.6; *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, __ F.3d __, No 99-50958, 2001 WL 21259, *2-3 (5th Cir. Jan. 9, 2001).

Landry's, slip op. at 64.

Similarly, the CC unequivocally states, "plaintiffs expressly exclude and disclaim any allegation that could be construed as alleging fraud or intentional or reckless misconduct." ¶1005. Thus, based on the recent Fifth Circuit decision in *Lone Star*, as well as the Court's recent opinions in *Landry's* and *U.S. Liquids*, Rule 9(b) clearly does not apply to plaintiffs' §11 claims.

2. This Court Has Found that Purchasers in the Aftermarket May Bring §11 Claims; the Statutory Framework and Ample Precedent Support that Holding

Section 11 of the Securities Act imposes liability upon directors, among other persons, when a registration statement contains an untrue statement of material fact or fails to disclose material information required to be stated therein or necessary to make the statements contained therein not misleading. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983). Section 11 "impos[es] a stringent standard of liability on the parties who play a direct role in a registered offering." *Id.* at 381-82. A plaintiff who "purchased a security issued pursuant to a registration statement ... need only show a material misstatement or omission to establish his prima facie case."

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[35] Although this Court has held, "boilerplate disclaimers of fraud" do not permit the Court to disregard fraud-based claims, the Court recognized "'where the complaint alleged incorrect financials based on the use of incorrect accounting rules, ***the allegations did not sound in fraud ... and thus were not subject to the requirements of Rule 9(b)***.'" *Kurtzman v. Compaq Computer Corp.*, No. 99-779, slip op. at 75 & n.27 (S.D. Tex. Apr. 1, 2002) (citing *Lone Star*, 238 F.3d at 369). Plaintiffs' claims here are based on admittedly "incorrect financials."

Id. at 382. Section 11 does not require a plaintiff to plead or prove scienter. *Id.* at 381-82; *Hochfelder*, 425 U.S. at 200 (congressional policy underlying §11 was to create liability regardless of fault). The rule is simple: if there is a material misstatement or omission in the registration statement, the buyer may sue the seller.

The Securities Act generally requires securities to be registered before they may be offered or sold to the public, *see* 15 U.S.C. §§77e-77f, and "[s]ections 7 and 10 of the Act set forth the information required in the registration statement and prospectus." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 570-71 (1995); *see* 15 U.S.C. §§77g, 77j. Section 11 of the Securities Act gives relief to "any person acquiring" a security ***issued*** pursuant to a materially incomplete or misleading registration statement. 15 U.S.C. §77k(a). If a security's registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, ***any person acquiring such security ... may, either at law or in equity ... sue***" the issuer, its directors, and every person who signed the defective registration statement as well as the underwriters of such security. 15 U.S.C. §77k(a). Thus, "[i]f a plaintiff purchased a security ***issued pursuant to a registration statement***, he need only show a material misstatement or omission to establish his prima facie case." *Herman & MacLean*, 459 U.S. at 382. Even those who buy the security after the issuer releases financial statements for more than a year following a registration statement's effective date may recover. 15 U.S.C. §77k(a). ***While those who acquire*** the subject securities ***after*** the issuer releases financial statements for a full year following the date a registration statement is deemed effective must plead and prove actual reliance, this provision is not implicated here as the plaintiffs bought in 01. *See* 15 U.S.C. §77k(e) and (g). Nothing in the statute suggests that investors must purchase "in" the offering in order to recover. Section 11's reliance and damages provisions would be nonsensical if that were the law.

Consistent with §11's text, courts "have uniformly allowed for recovery by purchasers in the aftermarket." *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1081 (9th Cir. 1999). In doing so, the court recognized that §11 affords relief to purchasers of registered shares, whether they acquired the registered shares ***in*** a public offering or not, if they can "trace" their securities to the offending registration statement. *See, e.g., Schwartz v. Celestial Seasonings*, 178 F.R.D. 545, 554-57 (D. Colo. 1998); *Adair v. Bristol Tech. Sys.*, 179 F.R.D. 126, 131-33 (S.D.N.Y. 1998).[36]

This Court has already rejected defendants' assertion that purchasers in the aftermarket do not have standing to bring a claim under §11. In *In re U.S. Liquids Sec. Litig.*, No. H-99-2785 (S.D. Tex. Apr. 30, 2002), the Court held: "Although there is a division of opinion among lower courts, all federal courts of appeals that have addressed the question have concluded that a secondary market purchaser who can trace his securities to a registered offering has standing to sue under §11." Slip op. at 14 (citing *Barnes v. Osofsky*, 373 F.2d 269, 271-73 (2d Cir. 1967) (Friendly, J.); *Herzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999); *Joseph v. Wiles*, 223 F.3d 1155, 1158-59 (10th Cir. 2000); *Versyss, Inc. v. Coopers & Lybrand*, 982 F.2d 653, 654 (1st Cir. 1992)).

Contrary to defendants' "secondary market purchasers" arguments (*see* Outside Dir. Br. at 58-9), §11 contains "no language which can be read to limit claims only to those investors who purchase their shares directly in a public offering." *Celestial Seasonings*, 178 F.R.D. at 555-56. Rather, "the statute contemplates relief for those who purchase shares after the public offering," *id.*, and "permits the ultimate investor to sue both the issuer and the underwriter notwithstanding a chain of title from issuer to underwriter to dealer to investor, and ***gives the same right of action even to a buyer in the open market.***" 9 Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 4267 (3d ed. 1995). Indeed, the Securities Act's House Report confirms this analysis: because the value of a security may be affected by the information given in the registration statement, §11(a)'s remedies "against those responsible for a false or misleading statement filed with the [SEC] are given to all purchasers ... ***regardless of whether they bought their securities at the time of the original offer or at some later date.***" H.R. Rep. No. 85, 73d Cong., 1st Sess., at 22 (1933). The

[36] In this respect, §11 differs from §12, which, by its terms makes one who uses a misleading prospectus to sell a security liable only "to the person purchasing such security from him." 15 U.S.C. §77(a)(2). This language in §12 "contemplates a buyer-seller relationship not unlike traditional contractual privity." *Pinter v. Dahl*, 486 U.S. 622, 642 (1988). As a practical matter, this may tend to limit §12(a)(2) claimants to persons who purchase from defendants "in" the offering – or at least in the 25 day post-offering period when pursuant to SEC Rule 174(d) the prospectus must be used by dealers who sell the securities.

report emphasizes that Congress desired to afford "a remedy to all purchasers who may reasonably be affected by any statements in the registration statement." *Id.*

Even at the time of its enactment, it was uniformly understood §11 protected post-offering purchasers of registered securities. William O. Douglas observed §11 protects an investor who "buys in the open market" because he "may be as much affected by the concealed untruths or the omissions as if he had read and understood the registration statement." William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale LJ 171, 176 (1933). Yale professor Harry Schulman similarly observed that under §11 an investor "may sue the persons named ***even though he purchased in the market after the securities had gone through several hands***." Harry Schulman, *Civil Liability and the Securities Act*, 43 Yale LJ 227, 248 (1933). Other law review analyses of the new legislation reflected the same view, that "a remedy is given to all persons 'acquiring' the security, even though it was not obtained directly from" the defendants, in an offering or otherwise. Note, *Legislation*, 33 Colum. L. Rev. 1220, 1229 (1933) (footnote omitted); *see id.* at 1228-29 & n.77 (contrasting §11 with §12). When Congress amended §11 the following year, to require proof of reliance from some subsequent investors,[37] the amending bill's Conference Report emphasized that §11's new "reliance" requirement would apply ***only*** to post-offering purchasers.[38]

In the face of this clear, easily understood liability theory and an admittedly false Registration Statement, the Outside Directors try to avoid liability by twisting both the CC's allegations and the provisions of the Securities Act. For example, defendants' argument regarding plaintiffs' §11 claim is that the 0 coupon Note offering was initially a private placement, for which no §11 liability exists, and that the subsequent resale to the public, since it was not the "initial placement," is likewise not actionable under §11. Outside Dir. Br., at 58-59. ***Unfortunately, what is missing from this "analysis" is the underlying fact of the Registration Statement filed by Enron for the resale of these very 0 coupon notes to the public effective 7/18/01***! ¶336. Taken as a whole, defendants' §11

[37] *See* Pub. L. No. 34-291, §206(a), 48 Stat. 881 (1934), codified at 15 U.S.C. §77k(a).

[38] Reliance would be required for purchases "after a period of 12 months subsequent to the effective registration date and then ***only*** when the issuer shall have published an earning statement to its security holders covering a period of at least 12 months after the registration date." H.R. Rep. No. 1838, 73d Cong., 2d Sess., at 41 (1934).

arguments are nothing more than a collection of erroneous facts (*e.g.*, there is no Registration Statement) combined with mis-cited authority (*e.g.*, plaintiffs are "secondary market purchasers" not entitled to bring a §11 claim) in an attempt to cloud what are otherwise clear-cut §11 claims. The Court should reject these arguments.

3. Plaintiffs Adequately Allege that the Registration Statements, Including the Prospectuses, Contained Material Misrepresentations and Omissions

Enron's Registration Statements used to sell securities during the Class Period incorporated by reference various of Enron's 10-K reports and other SEC filings (including 10-Q reports) and included Enron's released financial statements and reports. The Class Period offerings of Enron's securities included (¶612):

Registration Statements for Enron Offerings During the Class Period

Date of Offering	Date of Registration Statement	Description of Security	Annual Financial Statements/10Ks Incorporated by Reference	Quarterly Financial Statements Included or Incorporated by Reference
11/24/98	12/31/97	$250 million of 6 95% Notes	Registration Statement incorporated 96 10-K Future filings incorporated in the Registration Statement include the 97 10-K	10-Qs for 3/31/97, 6/30/97, 9/30/97
2/11/99	2/05/99	27.6 million shares of common stock @ $31 34	Registration Statement incorporated the 97 10-K	10-Qs for 3/31/98, 6/30/98, 9/30/98
5/19/99	2/05/99	$500 million 7.375% notes	Registration Statement incorporated the 97 and 98 10-Ks	10-Qs for 3/31/98, 6/30/98, 9/30/98
5/00 & 6/00	2/05/99	$325 million in 7.875% notes	Registration Statement incorporated 98 and 99 10-Ks.	10-Q for 3/31/00
7/18/01	6/01/01 & 7/13/01	Resale of Zero Coupon Convertible Notes	Registration Statement incorporated the 00 10-K	10-Q for 3/31/01

a. False and Misleading Financial Results and Related-Party Transaction Representations

Each of these Registration Statements was false and misleading due to the incorporation of Enron 10-Ks and 10-Qs that contained Enron's ***admittedly false financial statements for 97-00, which understated Enron's debt by billions of dollars and overstated its earnings by hundreds of millions of dollars***, as detailed in ¶¶418-611 of the CC. Enron's 97, 98, 99 and 00 financial statements were all restated and the restatement of previously issued financial statements is an admission they were materially false when made. While the Registration Statements included audited annual financial statements, significantly, they also incorporated all documents filed pursuant to §13(a) of the Exchange Act prior to the respective offerings, ***including Enron's 10-Qs which contained Enron's admittedly false and misleading unaudited quarterly financial results***.[39] ¶615. Of course, since the interim financial statements were unaudited they were not expertized and all signers of those Registration Statements are legally responsible for the accuracy of those interim unaudited financial statements.

Thus, under §11, each signer of these Registration Statements is *prima facie* liable to the purchasers of those securities subject to the ***defendants proving that they did not known in the exercise of due care or diligence***, and could not have known of the falsity of the Registration Statements containing these false financial results. Given the duration of falsity (over three years) and the size of the falsity (literally billions of dollars), the signers of these Registration Statements who foisted these worthless securities on the public face quite a burden in this regard.

However, the falsity of these Registration Statements was not confined to false financial statements. These Registration Statements were materially false in many other aspects. For instance, each of the Registration Statements contained a statement to the effect that any transactions Enron had entered into with "related parties" were on terms representative of those that could have been obtained from independent parties, obviously that statement is false. Given the looting of Enron that

[39] While the signers of these Registration Statements may be able at trial to establish a defense to liability for these expertized *i.e.*, certified financial statements, in light of the CCs allegations that they knew those annual certified financial statements were false, they may not do so now at the 12(b)(6) stage. *Murphy v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1996 U.S. Dist. LEXIS 22207 (D. Or. May 9, 1996).

occurred via the LJM2 partnership's SPE transactions with Enron, Enron's directors who repeatedly waived the conflict of interest policies to enable Fastow and other Enron employees to double deal via LJM2 will have a very difficult time proving that they did not know and in the exercise of due care could not have known of the falsity of these related-party transaction misrepresentations.

Each of these Registration Statements also contained false and misleading statements about Enron's financial-risk management and credit risk activities and capabilities, concealing the substance, nature, and effect of the non-arm's-length transactions Enron was entering into with related parties. The Registration Statements indicated that Enron had hedged risk in its earnings and equity and thus Enron's finances were secure and its credit standing and rating were sound when in fact Enron's financial structure was precarious in the extreme. ¶¶70, 126, 134, 164, 336, 393, 425, 612, 615.

b. False and Misleading Statements About EBS and the EIN

Each of the Registration Statements which incorporated Enron's 99 and 00 10-Ks contained false statements about Enron's EBS business, including the EIN. Enron's 99 10-K stated that "the Enron Intelligence Network (EIN) ... ***currently connects to most major U.S. cities ... " and "the EIN allows Enron to provide high quality delivery services for content providers." This was false because EBS had no "intelligent" network then – and never did***. ¶¶635-636. The EIN – which Enron defined as its network of fiber-optic lines connected by pooling points, at which bandwidth could be metered and directed, and the internally developed Broadband Operating System ("BOS") – was ***never*** completed. Although Enron had access to miles and miles of fiber-optic cable, only a tiny fraction of the lines were lit and connected at pooling points in the U.S By spring 99, EIN development had "deteriorated into chaos," as stated by a co-author of Enron's broadband business plan, and by 10/99 EBS was "in crisis mode." Simply stated, Enron's representation that EIN "***currently connects to most major U.S. cities***" was a lie. ¶635.

More importantly, Enron's BOS, which was to regulate the flow of bandwidth through Enron's fiber network – was a complete fiction. Enron publicly extolled a software application called InterAgent, which it inherited through its Modulus acquisition as the cornerstone of its unique BOS

– the purported intelligence behind the EIN. In reality, InterAgent was only a small piece of what was essential to develop the successful operating system that Enron represented it had. InterAgent was a communications software application – commonly called middleware – that enabled other applications to communicate with BOS. In fact, constructing an operating system around InterAgent was akin to building a car around a muffler – while a necessary component of the finished product, a muffler was a non-sensical component around which to build the product. ¶633.

In the end, ***InterAgent served no function in the BOS or the EIN*** for two reasons. ***First***, for InterAgent to work required an operating system into which it could connect. Enron's BOS was to be that operating system, ***but BOS never developed beyond the concept stage***. ***Second***, all Enron ever had resembling the BOS and the EIN were miles and miles of fiber – a little lit, but predominantly dark – some Sun Microsystems and Windows Media Player servers, and the InterAgent software. But Enron was unable to assemble this into a broadband system and make it work. ¶634.

Enron's 00 10-K, extolled the progress of the EIN's development (¶636):

> During 2000 Enron Broadband Services ***substantially completed the Enron Intelligence Network ("EIN")***, a high capacity, global fiber optic network which through pooling points can switch capacity from one independent network to another and create scalability.
>
> * * *
>
> At December 31, 2000, the EIN included ***25 pooling points of which 18 were in the U.S.*** and one each in Tokyo, London, Brussels, Amsterdam, Paris, Dusseldorf, and Frankfurt, allowing the EIN to ***connect to most major U.S. cities*** and a large number in Europe.
>
> * * *
>
> Enron's Broadband Operating System ***provides the intelligence to the EIN and connects to both physical and software network elements***. Enron's broadband operating system enables the EIN to: (i) provision bandwidth in real time; (ii) control quality and access to the network for internet service providers; and (iii) control and monitor applications ***as they stream over the network*** to ensure quality and avoid congested routes. ***Enron's broadband operating system automates the transaction process*** from the order's inception to electronic billing and funds transfer. As a result, ***the EIN allows Enron to provide high quality content delivery services for content providers*** and to contract for firm bandwidth delivery commitments to support Enron's bandwidth intermediation business.
>
> * * *

Enron ***provides premium broadband delivery services*** for media and entertainment, financial services, general enterprise and technology companies. The ***transportation of media-rich content, including live and on-demand streaming video, over the EIN*** significantly enhances the quality and speed to end-users from that provided by the public internet.

* * *

In implementing Enron's network strategy, Broadband Services is constructing the Enron Intelligent Network, a nationwide fiber optic network that consists of both fiber deployed by Enron and acquired capacity on non-Enron networks and is ***managed by Enron's Broadband Operating System software***.... Enron's bandwidth-on-demand platform ***allows delivery of high-bandwidth media-rich content such as video streaming, high capacity data transport and video conferencing***.

These statements were false because the EIN and the underlying BOS never worked. An internal EBS document showing data as of 12/00 reflected that only 3 U.S. cities – Las Vegas, Los Angeles, and New York – and London had pooling points that were running/operating by the end of the year, and pooling-point equipment installed in other cities was ***not yet operational because the equipment in each of those cities had not yet been connected to a network-operations center***, which was required before the pooling-point equipment could transmit bandwidth beyond that location. ¶637 Most of Enron's fiber-optic network was dark and not operating. In truth, Enron could not even make a broadband connection between Portland and Seattle, and was using ISPs to carry content that it represented to be transmitted by EIN's video-streaming. ¶639.[40]

c. False Statements Regarding EES

The Registration Statements that incorporated Enron's 99-00 10-Ks and 01 10-Q filings contain false statements about EES. Enron's 1stQ 01 10-Q stated that EES, which included commodity and energy-asset management and services contracts, had 1stQ 01 revenues of $693 million and income of $40 million, which was a dramatic improvement over 1stQ 00 revenue of $314 million and income of $6 million. The 10-Q stated the increase in EES revenues was "primarily .. a result of long-term energy contracts originated in 2001 and the growth of energy

[40] The 12/00 internal Enron document also reflects that the 3 U.S. locations were deemed operational only because of Enron's 5/00 acquisition of WarpSpeed, a California software company that had MetaRouter, a software application capable of regulating bandwidth capacity and supply-on-demand at pooling points. Enron used WarpSpeed's MetaRouter software in conjunction with third-party operating systems on the few hundred Sun Microsystems and Windows Media Player servers it had purchased, which Enron had to do because the BOS never worked. ¶638.

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services' European operations." These numbers were materially false and misleading because the revenue and income for both 1stQ 00 and 1stQ 01 were falsified and overstated due to overvaluation of the EES contracts and Enron's abuse of mark-to-market accounting as detailed at ¶¶418-611, 640. Likewise, in Enron's 00 10-K, Enron reported income for EES of $165 million, which was a huge increase over the reported $68 million loss in 99, and attributed 00 revenue and gross-margin increases – $2.8 billion and $331 million, respectively, compared to 99 – primarily to long-term contracts originated in 00 and the increase in value of the EES contract portfolio. Enron's 99 10-K stated that EES was a "nationwide provider of energy outsourcing products and services to business customers," including energy management services directly to commercial and industrial customers to reduce total energy costs, and reported EES total revenue of $1.8 billion. These numbers were false due to the accounting falsification and manipulations, as described in ¶¶418-611, 641. The Outside Directors received regular reports about EES, one of which was from Skilling.[41]

d. False and Misleading Statements About Enron's Capitalization

The Registration Statements, which incorporated Enron's 99-00 10-Ks, contained false and misleading statements about Enron's capitalization. These Registration Statements incorporated the following disclosure with either the same prices indicated or lower prices from Enrons 99-00 10-Ks (¶618):

> Enron is a party to certain financial contracts which contain provisions for early settlement in the event of a significant market price decline in which Enron's common stock falls below certain levels (prices ranging from $28.20 to $55.00 per share) or if the credit ratings for Enron's unsecured, senior long-term debt obligations fall below investment grade. The impact of this early settlement could include the issuance of additional shares of Enron common stock.

This purported disclosure was false and misleading because it misrepresented or concealed the nature, substance and effect of the "provisions for early settlement." ***First***, if Enron's stock price declined below the stated price levels, then Enron ***had*** to issue more shares – as it did in the Raptors – ***and the risk of this event was imminent***. ***Second***, the so-called disclosure concealed that in Enron's bogus hedge transactions Enron bore the ultimate risk of the so-called hedges – Enron was

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[41] *See* Exs. 24, 27.

actually hedging with itself, not really hedging – and thus was ***multiplying, not reducing its risk***. None of these matters were disclosed. The Outside Directors knew the undisclosed facts. ***They knew well that if Enron's stock price hit those triggers it would decimate Enron because of the quantity of shares that Enron would have to issue to bear the risk of the bogus hedges***. ¶619. ***Third***, the Registration Statements failed to disclose that "early settlement" could grossly dilute Enron's common stock as it did in the case of the bogus hedging transactions – "early settlement" was an imminent and highly negative risk. ***Fourth***, the Registration Statements did not disclose that the triggers concerning LJM2/Raptors transactions were, in fact, a massive credit support for Enron's bogus hedging transactions. ***Fifth***, the Registration Statements concealed the magnitude of the credit support, which in the case of the LJM2/Raptors transactions alone amounted to over $2 billion. And ***sixth***, the range of the triggers was materially misrepresented as well: the LJM2/Raptors transactions ranged from $57.50 to as high as $83 per share, which would have signaled much higher risk if the true price range and nature, substance and effect of the triggers were disclosed. Moreover, the cost to Enron just to maintain the credit support represented by the undisclosed triggers was approximately $500 million as of 4/02/01. ¶¶619-620.

The true effect of "early settlement" and the undisclosed triggers was that Enron was betting over 100 million shares of its own stock against market volatility and was ***multiplying, not reducing, the Company's risk***. To disclose this about the LJM2/Raptors' triggers (among others) would mean revealing the fact that Enron's hedging activities were not only bogus – the risk had not been truly hedged – but also that the purported hedging transactions had actually increased the risks to Enron, not reduced them. Enron's banks had structured and prepared the documents for the bogus hedging transactions. Simply stated, ***the stock price issuance triggers were toxic for Enron***. ¶621.

For example, in a 6/01 meeting between Enron managers and two CS First Boston managing directors – just a few weeks before the filing of the Registration Statement to permit the resale of Enron's $1.9 billion zero coupon convertible notes, which had been privately placed in 2/01 – CS First Boston discussed with Enron employees the public statements Enron was making in light of the undisclosed dire circumstances presented by the triggers in Enron's bogus hedging transactions. At that time, CS First Boston's managing directors stated, "How can you guys keep doing this?" –

referring to Enron's repeated statements to the market that its stock was undervalued. CS First Boston's managing directors continued that even at $40 per share, Enron's stock was still overvalued in their view: "***Do employees actually believe it's worth what management is saying?***" (At that time, Enron's stock was trading at approximately $48.50.) The CS First Boston managing directors added, "***You guys are at a critical price point right now***," referring to the bogus Raptors hedges, and stated that if Enron's stock continued to fall, that would cause Raptor to unwind and the massive credit support provided by Enron to come due. CS First Boston's managing directors asked the Enron managers, "Do you know how much off-balance sheet debt you [Enron] have?" When the Enron managers replied that they thought it was around one to two billion dollars, CS First Boston's managing directors stated, "***Try eight to 12 billion ... if Enron's stock hits $20 a share ... you guys are gonna be fucked***." ¶622.

It is obvious these misstatements misled market sophisticates, as when, in 3/01, Skilling indicated to analysts in response to Enron's equity issuance plans that Enron had some financing vehicles "**with *de minimus***" share issuance requirements, no analyst, money manager, or investor challenged this statement as incorrect or inconsistent with Enron's prior disclosures in that regard. ¶623.

e. False and Misleading Statements About Enron's Financial Risk Management

Enron's Registration Statements for securities sales in 00-01 also contained false statements about Enron's purported Financial Risk Management actions, skills and capabilities, incorporated from Enron's 99-00 10-Ks. These statements gave the false and misleading impression that Enron had greatly reduced the risk of its business through a series of sophisticated risk management techniques and risk analyses, and falsely quantified the components of market risk to which Enron was subject. The Registration Statements stated that Enron managed the components of its market risk (*e.g.*, commodity-price risk, interest-rate risk, foreign-currency exchange-rate risk, and equity risk) and its credit risk. Enron had materially compromised, if not altogether destroyed, its Financial Risk Management through its bogus hedging transactions. ¶624.

For example, the 00-01 Registration Statements for Enron's securities sales, incorporated from Enron's 99 and 00 10-Ks the following:

FINANCIAL RISK MANAGEMENT

* * *

Enron has performed an entity-wide value at risk analysis of virtually all of Enron's financial instruments, including price risk management activities and merchant investments. Value at risk incorporates numerous variables that could impact the fair value of Enron's investments, including commodity prices, interest rates, foreign exchange rates, equity prices and associate volatilities, as well as correlation within and across these variables.

The value at risk for equity exposure discussed above is based on J.P. Morgan's RiskMetrics (TM) approach.

¶625.

This was false and misleading. Enron had not done an "entity-wide value at risk analysis" and it had not analyzed its equity exposure because the results of the value-at-risk analysis, or "VaR," did not reflect the Company's leveraging of its equity in 99-01. ¶626. For example, in Enron's Registration Statements in 01, at a minimum, the results of the VaR did not reflect the massive amount of derivative securities trades that the banks had engaged in with Enron in negotiating and structuring the LJM/Raptors transactions and in participating as LJM2 investors. The derivatives trades Enron executed through LJM2 and the Raptors, in its bogus hedging transactions, with over $2 billion notional principal, destroyed Enron's Financial Risk Management because those trades leveraged Enron's own equity to extreme multiples. As a matter of market risk, these transactions were so dangerous to Enron that, internally, the banks referred to the trades or the risk they presented as ***"toxic waste" or "toxic."*** ¶626.

Enron's Registration Statements for its securities sales in 01 also incorporated "Non-Trading Market Risk" in the Financial Risk Management discussion for its 00 10-K which did not disclose or account for the actual impact of the leveraging of Enron's own stock in the LJM2/Raptors bogus hedging transactions. This resulted in a material understatement of Enron's Non-Trading Market Risk. In particular, the Equity category of Enron's Non-Trading Market Risk indicated $7 million for 00, meaning that in 00 there was a 5% chance that on any day Enron would lose $7 million in the event of a severe negative change in Enron's equity exposure. ***This indicated minimal risk.*** This statement was false and misleading. ***Enron's leveraging of its own stock in the LJM2/Raptors bogus hedging transactions in 00 alone increased Enron's equity risk materially higher than what was represented – approximately $100 million instead of $7 million – resulting from a severe negative change in Enron's equity exposure.*** ¶627.

f. False and Misleading Statements About Enron's Price Risk Management Activities and Financial Instruments

The Registration Statements for Enron's securities sales in 00-01 also made numerous misrepresentations concerning Enron's credit risk, incorporated by reference from Enron's 99-00 10-Ks. Enron's true credit risk was misstated and the false impression was given that Enron had minimized its credit risk. In truth, Enron had leveraged billions of dollars of its own stock as credit support for the purported third parties that it was dealing with in Enron's bogus hedging transactions through the LJM partnerships and the Raptors. The Outside Directors knew this because Enron provided the credit support such that it was the one ultimately bearing all the risk of the hedges in Enron's bogus hedging transactions through the LJM partnerships. ¶628.

The Registration Statements for Enron's 00-01 securities sales, incorporated the following statement from Enron's 10-Ks (¶629):

> Credit risk relates to the risk of loss that Enron would incur as a result of the nonperformance by counterparties pursuant to the terms of their contractual obligations. Enron maintains credit policies with regard to its counterparties that management believes significantly minimize overall credit risk. These policies include an evaluation of potential counterparties' financial condition (including credit rating), collateral requirements under certain circumstances and the use of standardized agreements which allow for the netting of positive and negative exposures associated with a single counterparty.
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> * * *
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> Enron does not anticipate any material impact to its financial position or results of operations as a result of nonperformance of third parties on financial instruments related to non-trading activities.

The 00 10-K, incorporated in Enron's 01 Registration Statements, further represented that Enron's total reserves for credit exposure were only $452 million as of year-end 00. ¶629. The statements above were false and misleading. Enron's credit exposure in 00 due to the LJM2/Raptors transactions ***alone*** – over $250 million – was not reflected in the reserves. In 01 Enron's credit exposure due to the LJM2/Raptors transactions, alone, was over $500 million as of 4/01 and $1 billion as of 7/01. And, contrary to what was represented, Enron did anticipate a material impact to its financial position due to Enron's credit exposure. Indeed, from the fall of 00 and during 01, Enron's stock price was spiraling downward, piercing equity issues, and triggering massive credit exposure to Enron. The house of cards was crumbling before the eyes of those who engaged and participated in constructing it. ¶630.

Contrary to the Outside Directors' unsupported arguments in their briefs, plaintiffs have more than met the Fifth Circuit's holding regarding misrepresentations and descriptions of why they are material. The Fifth Circuit has explained:

> Generally, like materiality, determining whether information has been adequately disclosed is a mixed question of fact and law and, therefore, is a question for a jury.... Consequently, we will only remove the question from the jury if the disclosure is so obvious that reasonable minds cannot differ.

Isquith, 847 F.2d at 208. Furthermore, the Court has held: "'The appropriate inquiry is whether, under all the circumstances, the omitted fact or the prediction without a reasonable basis "is one [that] a reasonable investor would consider significant in [making] the decision to invest, such that it alters the total mix of information available about the proposed investment."'" *BMC Software,* 183 F Supp 2d at 869, n.18 (quoting *Krim v. BancTexas Group*, 989 F.2d 1435, 1445 (5th Cir. 1993)). A determination of materiality, like the determination of whether defendants' disclosures are adequate, cannot be resolved at the 12(b)(6) stage. *Id. Lone Star*, 238 F.3d at 369.

4. Plaintiffs Do Not Have to Plead Reliance

The Outside Directors contend plaintiffs have to plead reliance on the allegedly untrue statements or omissions in the Registration Statements. The Outside Directors claim Amalgamated Bank, Hawaii Laborers, the Archdiocese of Milwaukee purchased securities ***after*** Enron had issued an earnings statement covering at least twelve months after the ***effective date*** of the Registration Statement. For Amalgamated Bank, defendants calculate the effective date from when Enron filed its Form 10-K in 00. This analysis erroneously construes the term ***effective date*** to mean either the original date or pre-effective date of the Registration Statement. In fact, Rule 158 defines the term ***effective date*** as follows:

> (c) For purposes of the last paragraph of section 11(a) only, the "effective date of the registration statement" is deemed to be the date ***of the latest to occur*** of (1) the

effective date of the registration statement; (2) the effective date of the ***last post-effective amendment*** to the registration statement, ***next preceding a particular sale by the registrant of registered securities to the public filed*** ....

Here Enron filed a post-effective Registration Statement on 3/1/00 and the Registration Statement for the 7.85% notes incorporated by reference Enron's 1stQ 00 10-Q, filed 5/15/00. These dates determine the effective date for purposes of §77k(a)(5). *See* 17 C.F.R. §230.158. Hawaii Laborers bought the notes the day before the Prospectus was issued, and the Archdiocese three days after the Prospectus was issued on 6/2/00. Amalgamated Bank purchased on 6/29/00. Therefore none of these plaintiffs need plead reliance.

5. Defendants Claim They Can Avoid Liability Under §11 Due to Their Reliance on Experts

The Outside Directors argue the CC provides a defense, namely, that they relied on the opinions of experts in signing the false Registration statements. Outside Dir. Br. at 64 Whether defendants can meet ***their burden of proof*** on this issue cannot be resolved at the 12(b)(6) stage.[42] *Murphy*, 1996 U.S. Dist. LEXIS 22207, at *23.

Defendants, ***not plaintiffs***, have the burden of proof here. Defendants need to assert the "due diligence" defense as an affirmative defense, and not give this explanation as a reason for plaintiffs failing to assert a claim.

The so-called expertized sections referred to by defendants were Registration Statements that were false and misleading due to the incorporation of Enron's 10-Ks and 10-Qs that contained Enron's admittedly false financial statements for 97-00, which understated Enron's debt by billions of dollars and overstated its earnings by hundreds of millions of dollars, as detailed in ¶¶418-611. While the Registration Statements included audited annual financial statements, significantly, they

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42 Section 11(b) provides that:

> [N]o person, other than the issuer, shall be liable ... ***who shall sustain the burden of proof*** .. that ... as regards any part of the registration statement not purporting to be made on the authority of an expert ... he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading ....

15 U.S.C. §77k(b)(1)(3).

also incorporated all documents filed pursuant to §13(a) of the Exchange Act prior to the respective offerings, ***including Enron's 10-Qs which contained Enron's admittedly unaudited false and misleading quarter financial results***. ¶615. Of course, since the interim financial statements were unaudited, ***they were not expertized*** and all signers of those Registration Statements are legally responsible for the accuracy of those interim unaudited financial statements. And since an accountant's liability under §11 is limited to those figures which he certifies and does not extend to those financial statements contained in unaudited statements, defendants cannot hide behind so-called expertized financial statements in unaudited financial statements that they have approved. *See Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643, 684 (S.D.N.Y. 1968) (accountants who certified certain financial statements contained in the prospectus were not held responsible for those interim figures that they did not certify).

Finally, the Audit Committee of Enron's Board had actual notice on at least three occasions, 2/7/99 Audit Committee Meeting, the 5/00 Audit Committee Meeting and the 2/12/01 Finance Committee Meeting, that Enron's accounting in its core business areas was highly risky and subject to scrutiny or reversal. Therefore the Outside Directors had no reasonable ground to believe the statements were true and failed to conduct any reasonable investigation when they were given explicit knowledge of the falsehood.

6. Defendants' Claims that They Did Not Sign or Were Not Board Members at Relevant Times Must Fail

Walker's claim that he was not a director at the time the 5/19/99 and 7/18/01 offerings became effective (Outside Dir. Br. at 61) does not provide a grounds for dismissal of the §11 claims against him. Plaintiffs allege regardless of whether he was a director at the time, Walker signed those Registration Statements, which he does not dispute. 15 U.S.C. §77k provides:

> (1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or
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> * * *

> Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof ....

Walker has not sustained that burden of proof at this stage and therefore the claim against him should not be dismissed.[43]

F. Plaintiffs' Control Person Claims Should Be Sustained

Under §15 of the Securities Act and §20(a) of the Exchange Act , liability attaches to one who "controls" a person who violates any provision of the securities laws. To state a valid claim under §§15 or 20(a), a plaintiff need only allege (i) a violation of the securities laws and (ii) the defendant was a controlling person with respect to the violation within the meaning of §§15 and 20.[44] *See Landry's*, slip op. at 11 n.14 (citing *Ellison v. Am. Image Motor Co.*, 36 F. Supp. 2d 628, 637-38 (S.D.N.Y. 1999)); *Christoffel v. E.F. Hutton & Co.*, 588 F.2d 665, 667 (9th Cir. 1978); *Stern v. Am. Bankshares Corp.*, 429 F. Supp. 818, 823 (E.D. Wis. 1977). As the Fifth Circuit held in *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957 (5th Cir 1981), "'[t]he term "control" ... means the

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43 Plaintiffs are no longer pursuing §11 claims on the 7% Exchangeable Notes. Thus, Meyer and Winokur's arguments as to the 8/99 offering are moot. Plaintiffs have also withdrawn their §11 claims against Foy and Meyer as to the 7/01 offering.

44 Although worded differently, the control person liability provisions of §15 of the Securities Act and §20(a) of the Exchange Act are interpreted in the same way. *See First Interstate Bank, N.A. v. Pring*, 969 F.2d 891, 897 (10th Cir. 1992), *rev'd on other grounds sub nom. Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). Section 15 of the Securities Act, 15 U.S.C. §77(o), provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 11 or 12 ... shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Section 20(a) of the Exchange Act, 15 U.S.C. §78t(a), contains an analogous control person provision:

> Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'" (citing 17 C.F.R. §230.405(f) (1979)). *See also Landry's*, slip op. at 12 n.14 (citing *Ellison*, 36 F. Supp 2d at 638); *First Jersey*, 101 F.3d at 1473.

To successfully plead control person liability, plaintiffs need ***not*** allege the controlling person actually participated in the securities violation. "The Fifth Circuit has stated that a plaintiff need only show that the alleged control persons possessed ***'the power to control*** [the primary violator], not the exercise of the power to control.'" *BMC Software*, 183 F. Supp. 2d at 869 n.16. Similarly, in *U.S. Liquids*, the court noted in *Abbott v. Equity Group*, 2 F.3d 613, 620 (5th Cir. 1993), the Fifth Circuit held plaintiffs need ***only*** show the power to control, '"not the exercise of'" that power. 2001 U.S. Dist. LEXIS 23518, at *14. As this Court noted in *Landry's*, control may be established by

> demonstrating that the defendant possessed the power to direct or cause the direction of the management and policies of a person through ownership of voting securities, by contract, ***business relationships, interlocking directors***, family relations ships[sic], and ***the power to influence and control the activities of another***.

Landry's, slip op. at 12 n.14 (citing *Ellison*, 36 F. Supp. 2d at 638). Thus, courts will generally find control person liability if plaintiffs make a *prima facie* showing that defendants "had the ***power*** (whether exercised or not) to control the transactions in question and to control the operations ... in general. In other words, it is ***enough*** if the Defendant simply had the ***abstract power*** to control. ***Actual exercise*** of that power is ***not*** required." *McNamara v. Bre-X Minerals, Ltd.*, 46 F. Supp. 2d 628, 635 (E.D. Tex 1999) (emphasis in original).[45]

Plaintiffs have adequately alleged underlying or "primary" claims against Enron for violations of §10(b) and that defendants' possessed the power to control the primary violator – Enron.

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[45] Reliance on *Dennis v. General Imaging, Inc.*, 918 F.2d 496 (5th Cir 1990), is misplaced. *Dennis* incorrectly states that *Thompson* requires defendants' participation to establish a §20(a) violation. The Fifth Circuit rectified this error in *Abbott*, 2 F.3d at 620 n.18 ("*Dennis* does not accurately reflect our rejection in *Thompson* of a 'culpable participation' requirement."). Despite this clarification, defendants have cited a number of district court cases in the Fifth Circuit which mistakenly follow *Dennis*, instead of *Thompson* and *Abbott*. Because the Fifth Circuit has mandated a different approach than other jurisdictions (*see McNamara*, 46 F. Supp. 2d at 637 n.12), defendants' authorities from outside this circuit are inapplicable. ***There is no culpable participation doctrine in this circuit***.

Accordingly, plaintiffs' "control person" claims should be sustained. *See Robertson*, 32 F. Supp. 2d at 451; *Zuckerman*, 4 F. Supp. 2d at 627-28.

G. Plaintiffs Have Stated a Claim for Defendants' Violation of the Texas Securities Act

1. The Individual Defendants Are Liable for Offering and Selling Enron Securities

Contrary to their assertions, the directors and officers are liable under art. 581-33A of the Texas Securities Act. Indeed, defendants err in arguing that the term "seller" is to be narrowly or technically construed; further, the issue is irrelevant to the degree that each is liable as a control person and/or aider and abettor.

The term "seller" is not narrowly construed. Indeed, all of the officer and director defendants fit this definition. The court in *Rio Grande Oil Co. v. State*, 539 S.W.2d 917 (Tex. App. - Houston [1st Dist.] 1976, writ ref'd n.r.e.), addressed who is a "seller" for purposes of the Texas Securities Act, stating:

> Article 581-12 provides that "no person, firm, corporation or dealer shall directly ***or through agents or salesmen***, offer for sale, sell or make a sale of any securities in this state ...." The provisions of the Security Act are broad. The terms "sale", "offer to sell", and "sell" are defined in Article 581-4E as including every disposition, or attempt to dispose of a security for value. In the words of the Act, ***the seller may be any link in the chain of the selling process***. He is the one who performs "***any act by which a sale is made***." *Brown v. Cole*, 155 Tex. 624, 291 S.W.2d 704 (1956).

Id. at 922; *see also Texas Capital Secs., Inc. v. Sandefer*, 58 S.W.3d 760, 776 (Tex. App. - Houston [1st Dist.] 2001, pet. denied) ("The Act applies if the seller is any link in the chain of the selling process."). Here, the individual director and officer defendants were a link in the selling process – they either prepared or signed the offering documents or otherwise were involved in the selling process. *See, e.g.*, ¶¶83-88, 1020-1027.

Analogizing to federal case law, defendants make the related argument that they themselves did not sell the securities directly to plaintiffs because the sales were pursuant to a "firm commitment offering." *See* Outside Dir. Br. at 78-79. Defendants' position would render not only the language of the Texas Securities Act meaningless, but limit the reach of the statute in direct contradiction of the Texas legislature's intent. "The term 'sell' means 'any act by which a sale is made,' and the term 'sale' or 'offer for sale' shall include ... an offer to sell, ***directly or by an agent or salesman*** ... ."

Anheuser-Busch Cos. v. Summit Coffee Co., 934 S.W.2d 705, 707-08 (Tex. App. - Dallas 1996, writ dism'd) (citing Tex. Rev. Civ. Stat. Ann. art. 581-4(E) (Vernon Supp. 1996)). As the vast majority of public offerings are firm commitment offerings, whereby the issuer does not sell directly to the purchasers, the legislature's definition of "sale" clearly was drafted to encompass this process.[46]

Notwithstanding the 1977 revisions to the Texas Securities Act, directors and officers remain liable under art. 581-33 as control persons for actions taken in connection with public offerings "if they ***directly or indirectly control a seller***, buyer ***or issuer*** of a security." *Frank v. Bear*, 11 S.W.3d 380, 383 (Tex. App. - Houston [14th Dist.] 2000, pet denied) (citing 581–33F §1). The *Frank* court further stated:

> "[T]he rationale for control person liability is that a control person is in a position to prevent the violation and may be able to compensate the injured investor when the primary violator (*e.g.*, ***a corporate issuer*** which has gone bankrupt) is not." The comment also notes that "a control person might include an employer, an ***officer or director***, a large shareholder, a parent company, and a management company." *Id.* Control is defined in the same terms as under federal securities law; under that law "control means the possession, direct or indirect, of the power to direct or cause the direction of the management or policies of a person, whether through the ownership of voting securities, by contract, or otherwise. *Id.*

Id. at 383-84. Therefore, Enron's directors and officers, persons in control of Enron – the corporate issuer – cannot escape liability by claiming that "the only sellers [plaintiffs] identify are JP Morgan and Lehman Brothers." *See* Outside Dir. Br. at 79.

2. Defendants' Misstatements Induced Plaintiffs' Purchase of the Securities

The Outside Directors contest plaintiffs' claims under the Texas Securities Act because the allegations of the CC only "relate to offerings and events that occurred after October 1998," and that's after plaintiffs purchased the Notes. *See* Outside Dir. Br. at 76. This is gross misrepresentation of the CC.

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[46] Defendants cite cases holding issuers in firm commitment underwriting not liable under §12(a)(2) of the Securities Act. *See* Outside Dir. Br at 79. These are clearly off-base. The two statutes are not interpreted to have the same meaning. According to *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194 (1st Cir. 1996), cited by defendants: "'It seems quite clear that § 12 contemplates only an action by a buyer against his or her immediate seller.'" *Id.* at 1216. As interpreted by the courts and shown above, the same cannot be said for plaintiffs' claim under the Texas Securities Act. Indeed, the "language used in the Texas Securities Act is broader than that used in its federal counterpart." *Texas Capital*, 58 S.W.3d at 776.

For example, plaintiffs' introduction includes: "Year-End 97 Crisis." *See* ¶¶9-11; *see also* ¶¶613-617. This section details how Enron's year-end 97 financial statements, which were incorporated into the documents used to sell the Notes, were falsified by the (now infamous) fraudulent creation and use of the JEDI/Chewco SPEs. *Id.* This enabled Enron to improperly recognize $45 million of revenue and hide $700 million worth of debt. ¶11. These events took place ***before*** 98, despite defendants' suggestion that the CC only relates to fraudulent actions occurring after 10/98. Another example of fraud occurring in 97, detailed in the CC, is Enron International's improper repeated deferral of start-up and proposal costs even after bids failed. These deferrals included developer, financing and promotional fees, that were incurred on ***failed*** project proposals. ¶¶121(f), 614. These deferred expenses were accumulated for more than five years – between 93 and 97 – a practice known inside Enron as "***snowballing***." *Id.* Both the JEDI/Chewco transactions and the "snowballing" made Enron's 97 financial statements false. The accounting manipulations committed by defendants, including those detailed above, were included in Enron's 97 Form 10-K, rendering the Form 10-K false and misleading. Enron's 97 Form 10-K, which was filed in ***3/98***, was incorporated by reference into the Registration Statement which was used to sell the Notes The Washington Board bought the Notes in 7/98. ¶613. Also, the 7/7/98 Prospectus incorporated Enron's 3rdQ 97 10-Q which improperly accounted for contracts in Enron's EES department. ¶¶613, 615. Thus, it is quite clear that plaintiffs plead improper conduct which induced their purchases.

3. Plaintiffs Adequately Plead Aider and Abettor Liability Under the Texas Securities Act

a. Plaintiffs Have Adequately Alleged Defendants' Violations of the Texas Securities Act

Texas law imposes joint and several liability for anyone who "directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids ... [an] issuer of a security" in violation of the Texas Securities Act. *Frank*, 11 S.W.3d at 384. "In order to establish aiding and abetting liability plaintiffs must demonstrate 1) that a primary violation of the securities laws occurred; 2) that the alleged aider had 'general awareness' of its role in the violation; 3) that the actor rendered 'substantial assistance' in this violation; and 4) that the alleged aider either a) intended to deceive plaintiff or b) acted with reckless disregard for the truth of the representations made by the primary violator." *Id.*; *Crescendo Invs., Inc. v. Brice*, 61 S.W.3d 465, 472 (Tex. App. - San Antonio 2001, pet. denied). The CC satisfies each of these requirements.

b. Enron Committed a Primary Violation of the Texas Securities Act

An issuer of securities is strictly liable for untrue statements of material fact contained in a prospectus accompanying a public offering. Tex. Rev. Civ. Stat. Ann. art. 581-33C(2) (Vernon 2001). Enron's offering documents incorporated Enron's financial statements, including the representations concerning Enron's levels of debt and earnings, which were manipulated by, among other things, the defendants' use of SPEs and partnerships to engage in the transactions detailed in the CC, the abuse of mark-to-market accounting, the creation of hidden loans, etc. By restating these financial statements, Enron and the Enron defendants have now admitted that these offering documents were untrue statements of material fact. *See* APB Opinion 20, at ¶13; *In re Telxon Corp. Secs. Litig.*, 133 F. Supp. 2d 1010, 1026 (N.D. Ohio 2000) ("Telxon, itself, admitted its prior disclosures were materially misstated when it issued the restatements which gave rise to this litigation."). Enron thus violated the Texas Securities Act. Tex. Rev. Civ. Stat. art. 581-33C(2).

c. Each Defendant Had a General Awareness of Its Role in Enron's Violations and Rendered Substantial Assistance to Enron

Each defendant had a general awareness of its role in Enron violating the Texas Securities Act. *See* Section on Rule 96 Particularity. Each defendant has performed actions in furtherance of the fraudulent scheme, as demonstrated herein. *See* Section on Rule 9(b) Particularity. These allegations are sufficient to show each defendant "was generally aware of its role in a securities violation by a primary party." *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990).

Plaintiffs need not allege that each defendant was aware of its role in the underwriters' violations of the Texas Securities Act. This is not necessary because each defendant materially aided Enron's – the issuer's – violations of the Texas Securities Act. "A person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth of the law materially aids

... [an] issuer of a security is liable under Section . . 33C jointly and severally with the ... issuer, and to the same extent as if he were the ... issuer." Tex. Rev. Stat. Art. 581-33F(2).

4. Defendants' Violations of the Texas Securities Act Are Actionable Even Though They Predate the Federal Class Period

The Outside Directors argue that plaintiffs' claims under the Texas Securities Act fail as a matter of law because "none of the allegations or purchases on which Washington Board's claim is based occurred during the class period." Outside Dir. Br. at 75. Defendants are wrong. The Class Period defendants refer to is only the "Federal Class Period" – as explicitly stated in paragraph 121 of the CC. Only the Federal Class Period began on 10/19/98. The beginning date of the Federal Class Period is by operation of law 10/19/98, because §10(b) claims are governed by a three-year statute of repose, and plaintiffs' claims were filed on 10/19/01. *See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). The Texas Securities Act, however, does not impose a three-year statute of repose. Rather, the Texas Securities Act has a three-year statute of limitations ***and a five year statute of repose***. Tex. Rev Civ. Stat. art. 581-33H(2).[47] Because plaintiffs' state law claims are not subject to the three-year statute of repose, which limits the Federal Class Period as defined, it is clear that the pertinent period for plaintiffs' Fourth Claim for Relief includes misrepresentations made during a period of time prior to the federal statute of repose.[48] The misrepresentations made by defendants during the Federal Class Period do not impact or limit plaintiffs' claims under the Texas Securities Act.

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[47] Indeed, plaintiffs allege that, at the time the CC was filed, less than three years had passed since the Washington Board discovered, or could have discovered via the exercise of reasonable diligence, the fraud alleged in the CC ¶1030. Further, plaintiffs alleged that less than five years had elapsed from the time the securities at issue were offered. *Id.*

[48] If the Court so desires, plaintiffs will amend their complaint to expressly so state.

IV. Conclusion

Accordingly, based on the above, plaintiffs' allegations are sufficient as a matter of law to withstand a motion to dismiss under Rule 12(b)(6). Defendants' Motion to Dismiss should be denied in its entirety.

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Respectfully submitted,

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